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### INVESTMENT REGULATION AND CONFLICTS OF INTEREST IN EMPLOYER-MANAGED PENSION PLANS

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#### INTRODUCTION

In 1964, the Studebaker plant in South Bend, Indiana closed its doors, terminated its pension plan, and, as a result, unexpectedly affected the retirement security of 10,500 workers. Although the pension plan had been in operation for only 14 years, the trust had accumulated \$25 million in assets. Nonetheless, the final distribution of these assets eventually left 4,000 employees between the ages of 40 and 60 with only 15 percent of their accrued benefits, and 2,900 workers under the age of 40 with absolutely nothing.<sup>1</sup>

The Studebaker experience is not unique. In 1972, 1,227 terminated pension plans were reported to the Internal Revenue Service.<sup>2</sup> Nineteen thousand four hundred claimants, covered by 546 of these

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<sup>1</sup> See HOUSE COMM. ON WAYS AND MEANS, PRIVATE PENSION TAX REFORM, H.R. REP. NO. 807, 93d Cong., 2d Sess. 13 (1974); PRIVATE WELFARE AND PENSION PLAN STUDY, 1972, REPORT OF HEARINGS ON PENSION PLAN TERMINATIONS, BEFORE THE SUBCOMM. ON LABOR OF THE SENATE COMM. ON LABOR AND PUBLIC WELFARE, 92d Cong., 2d Sess. 1-2 (1972). See also 118 CONG. REC. 21672 (1972) (remarks of Rep. Wyatt).

<sup>2</sup> DEPARTMENT OF THE TREASURY AND DEPARTMENT OF LABOR, STUDY OF PENSION PLAN TERMINATIONS, 1972; FINAL REPORT 2 (1973) [hereinafter TERMINATIONS]. This report, published jointly by the two departments, sets forth the results of a study of all single-employer pension plan terminations which were reported to the IRS during 1972 and all multi-employer plan terminations reported between January 1965 and December 1971. *Id.* at 1. The statistics cited refer to single-employer plans. Data available for multi-employer plans indicates that an overwhelming majority of reported plan terminations occur on the merger of one plan into another and therefore benefit losses are negligible. *Id.* at 76, 80.

plans, lost a total present value of \$48.7 million in accrued retirement benefits.<sup>3</sup> While claimants losing benefits in 1972 represented less than .08 percent of all workers covered by private pension plans,<sup>4</sup> the spectre of the Studebaker case has nevertheless sensitized the public to the vast potential for social dislocation inherent in the failure of any retirement income plan. Although the incidence of benefit loss has continued to be negligible, the problem of benefit security has become increasingly important as both pension coverage and public reliance on privately sponsored retirement income plans expand.

The market value of the total assets of private, non-insured pension funds was \$150 billion at the end of 1972.<sup>5</sup> Dr. Roger Murray of Columbia University, speaking in the wake of the dramatic Studebaker termination, noted that "no aggregation of financial assets [so large had] ever escaped close regulation."<sup>6</sup> While statutory regulation of private pension plans did exist at that time, the efficacy of this regulation in protecting employee expectations was questionable. Federal regulation centered around the indirect control afforded by awarding tax benefits<sup>7</sup> to pension funds that complied with conditions specified in the Internal Revenue Code (the Code).<sup>8</sup> Under the Code, however, the only sanction that existed for failure to comply with the specified conditions was withdrawal of the plan's tax-exempt status.<sup>9</sup> Because this sanction was so drastic it was rarely invoked. Consequently, the effectiveness of the Code's regulation was seriously undermined.<sup>10</sup>

An attempt was also made on the federal level to regulate pension funds through the Welfare and Pension Plans Disclosure Act (WPPDA).<sup>11</sup> However, WPPDA's reliance on pension plan ben-

<sup>3</sup> *Id.* at 18.

<sup>4</sup> *Id.* at 19.

<sup>5</sup> *Private Noninsured Pension Funds, 1972*, 32 SEC STAT. BULL. 283 (1973) [hereinafter *Private Funds*].

<sup>6</sup> Murray, *Pensions and Public Policy*, in PROCEEDINGS OF FIRST ANNUAL CORPORATE PENSION FUND SEMINAR 41 (1964).

<sup>7</sup> See INT. REV. CODE OF 1954, §§ 402 (a)(1), (2), (5), 404(a)(1) & 501(a).

<sup>8</sup> See *id.* § 401(a).

<sup>9</sup> A pension plan's tax exemption can be withdrawn if those charged with the management of the plan engage in any transactions prohibited by § 503 of the Code. See Note, 88 HARV. L. REV. 960, 960-61 (1975) and note 107 *infra*.

<sup>10</sup> S. REP. NO. 383, 93d Cong., 1st Sess. 18 (1973). See also Statements of Hon. Thomas R. Donahue, Ass't Sec'y of Labor for Labor-Mgmt. Relations, *Hearings on H.R. 5741 Before the General Subcomm. on Labor of the House Comm. on Ed. & Labor*, 90th Cong., 2d Sess. 51 (1968):

The loss of the tax-exempt status may affect the interest of the participants and beneficiaries in the plan more adversely than the interests of those charged with its administration.

As a practical matter, therefore, the provisions of the Internal Revenue Code have not been adequate to maintain fiduciary responsibility on the part of persons handling welfare and pension funds.

*Id.* at 54.

<sup>11</sup> Welfare and Pension Plans Disclosure Act of 1958, Pub. L. No. 85-836, §§ 2-10, 72 Stat. 997, as amended, 29 U.S.C.A. §§ 1001 *et seq.* (1975).

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efficiaries to enforce its provisions did not prove effective.<sup>12</sup> Thus, both federal statutes were generally inadequate. Additionally, in almost every case in which pension plan participants lost their benefits, the loss was occasioned not because of some violation of federal law, but rather because of the manner in which the plan was executed with respect to its contractual requirements of vesting and funding.<sup>13</sup> The state courts compounded this problem by strictly interpreting pension plan indentures and by failing to apply liberally the concept of equitable relief or to disregard overly technical wording in pension plan documents.<sup>14</sup> This judicial parochialism decreased the capacity of contract and trust principles, particularly the prudent man standard, to effectively monitor abuses in the management of pension fund assets.<sup>15</sup>

Congress responded to this situation by enacting the Employee Retirement Income Security Act of 1974 (ERISA).<sup>16</sup> The underlying purpose of the Act is to insure that employees and their beneficiaries will not be deprived of benefits anticipated under pension plans.<sup>17</sup> To accomplish this end, ERISA provides minimum participation and vesting standards,<sup>18</sup> repeals WPPDA,<sup>19</sup> institutes stricter reporting and disclosure requirements,<sup>20</sup> adopts a federal prudent man standard for fiduciaries,<sup>21</sup> establishes minimum funding requirements,<sup>22</sup> and creates a reinsurance program.<sup>23</sup>

In 1965, a comprehensive report to the President on public policy and private pension programs concluded:

This Committee recognizes the need for additional measures for the protection of the interests of employees but doubts whether a major problem is the lack of "appropriate standards of prudence." The chief problem, rather, is one of enforcing existing standards of fiducial obligations of trustees . . . . [P]rivate retirement funds are especially well suited to be flexible and responsive to changing investment opportunities. . . . The question is how to permit broad exercise of discretion on the part of trustees or plan managers but to hold them to the highest standards of fiducial responsibility. Regulations or formulas for asset

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<sup>12</sup> See text at notes 161-173 *infra*.

<sup>13</sup> S. REP. NO. 93-127, 93d Cong., 1st Sess. 5 (1973).

<sup>14</sup> See Levin, *Proposals to Eliminate Inequitable Loss of Pension Benefits*, 15 VILL. L. REV. 527, 566 (1970).

<sup>15</sup> See text at notes 124-147 *infra*.

<sup>16</sup> 29 U.S.C.A. §§ 1001-1381 (1975).

<sup>17</sup> *Id.* § 1001.

<sup>18</sup> *Id.* §§ 1052, 1053.

<sup>19</sup> *Id.* § 1031.

<sup>20</sup> *Id.* §§ 1021-31.

<sup>21</sup> *Id.* § 1104.

<sup>22</sup> *Id.* §§ 1081-86.

<sup>23</sup> *Id.* §§ 1301-81.

management would reduce this flexibility without the likelihood of improving the quality of the judgment and discretion exercised by trustees or plan managers.<sup>24</sup>

Congress apparently adopted the conclusions of the President's Report pertaining to investment constraints, for ERISA conspicuously avoids direct regulatory controls over pension fund investments. While prohibiting certain transactions between parties in interest and the trust fund,<sup>25</sup> the legislation generally reaffirms confidence in a rule of prudence, and effectively federalizes the protections which have nominally been available at the state level through the law of trusts.<sup>26</sup> As noted in the Senate Report on ERISA, "[a] fiduciary standard embodied in federal legislation is considered desirable because it will bring a measure of uniformity in an area where decisions under the same set of facts may differ from state to state."<sup>27</sup> An implied assumption of the statute appears to be that the failure of state trust law to adequately safeguard the interests of employees under benefit trusts resulted from a failure of administration rather than substance. This assumption, however, is subject to some doubt.

In recognition of the increasingly speculative leanings of pension fund management since 1965, it does not seem unreasonable to re-examine the conclusions of the President's Report and the Congress regarding the undesirability of direct investment restraints. Common stock holdings, as a percentage of the total assets of private non-insured pension funds, rose from 54.8 percent in 1965 to 73 percent in 1972.<sup>28</sup> Moreover, asset managers and corporate trustees have demonstrated an increasing interest in portfolio performance. Indeed, the investment potential of pension funds has generated an entire "mini industry" of pension managers, advisory firms, actuaries and performance measurement services.<sup>29</sup> Finally, the effects of inflationary pressures and collective bargaining demands on the costs of establishing and maintaining a pension plan have also encouraged em-

<sup>24</sup> PRESIDENT'S COMMITTEE ON CORPORATE PENSION FUNDS AND OTHER PRIVATE RETIREMENT AND WELFARE PROGRAMS, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS: A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS 73-74 (1965).

<sup>25</sup> 29 U.S.C.A. § 1106.

<sup>26</sup> See *id.* §§ 1103-14. See text at notes 90-147 *infra*.

<sup>27</sup> S. REP. NO. 127, 93d Cong., 1st Sess. 29 (1973).

<sup>28</sup> See *Private Funds*, *supra* note 5, at 286 (Table 1). Private, non-insured pension funds owned \$46 billion of common stock at the end of 1969 compared with less than \$11 billion in 1960. *Hearings on Investment Policies of Pension Funds Before the Subcomm. on Fiscal Policy of the Joint Economic Committee*, 91st Cong., 2d Sess. 4 (1970) [hereinafter *Investment Policies*]. During 1969, the assets of private, non-insured pension funds increased by \$7 billion, which included a record \$5 billion increase, up 11% from the previous year, in holdings of common stock. *Id.* at 27. These percentages are based on the aggregate market value of securities held in private pension portfolios as set forth in *Private Funds*, *supra* note 5, at 286 (Table 1). An even more dramatic increase appears if book value is used as a measure: 42.4% in 1965 and 63.3% in 1972. *Id.*

<sup>29</sup> For an overview of the pension fund "industry," see Institutional Investor, vol. V, No. 9 (August 1971).

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ployers and corporate trustees to pursue profitable investments and emphasize high returns.<sup>30</sup>

In light of this current trend in pension fund management, a serious question arises as to whether the enactment in ERISA of a federal fiduciary standard to monitor the investment of pension fund assets adequately responds to the needs addressed by the Act or fully reflects the values it endorses. It is the purpose of this study to evaluate ERISA by examining the federal fiduciary standard. In this regard, mechanical aspects of pension plans which have proven particularly conducive to abuse will first be discussed; historical developments which have hastened this inherent potential for abuse will be highlighted. Both state and federal attempts at pension plan regulation prior to ERISA will then be examined in an attempt to ascertain the significance and capabilities of ERISA's provisions. It will be submitted that by failing to adopt a more explicit standard for the investment of pension funds than that which previously existed under state law and by relying on the initiative of individual employees to enjoin wrongdoing, the Act retains the most basic shortcomings of prior law. Thus, it will be concluded that the Act's ultimate significance lies in its capacity to mitigate the consequences of pension fund failure, rather than to eliminate the causes.

### I. THE PENSION PLAN

As defined in the Employee Retirement Income Security Act of 1974, an "employee pension benefit plan" is

[A]ny plan, fund or program which was heretofore or is hereafter established or maintained by an employer or an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program—

(A) provides retirement income to employees, or

(B) results in a deferral of income by employers for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.<sup>31</sup>

The basic concept of a pension plan consists of an employer's promise of retirement income to each employee who meets specific criteria of eligibility.

There are two basic types of pension plans recognized by the

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<sup>30</sup> See *Investment Policies*, *supra* note 28, at 28.

<sup>31</sup> 29 U.S.C.A. § 1002(2).

Act—the defined contribution plan<sup>32</sup> and the defined benefit plan.<sup>33</sup> Either type may require employee as well as employer contributions. However, in the defined contribution plan the rate or amount of employer contributions for each employee is fixed.<sup>34</sup> The employee's ultimate benefit thus depends upon the amount contributed and upon the fund's rate of return.<sup>35</sup> In contrast, under a defined benefit plan, the employee's pension is fixed in advance by a benefit formula and does not depend upon fund performance.<sup>36</sup> Thus, the contributions of the employer must be sufficient to meet the liabilities of the fund.<sup>37</sup> Many employers provide their employees with a defined benefit plan and a supplementary defined contribution plan.

In 1973, more than half of the industrial work force participated in private pension plans.<sup>38</sup> Despite their variety of form, the great majority of retirement plans are shaped by the qualification requirements of section 401(a) of the Internal Revenue Code. In fact, a survey of private pension plans on file in 1970 revealed that nearly all met the Code's standards for exemption.<sup>39</sup> Tax inducements,<sup>40</sup> however, are not the sole explanation for the current rise in the number of pension plans.<sup>41</sup> Where plans are sponsored by employers, pension benefits serve to increase the productivity of the employee group—retirement security boosts employee morale and enables employers to attract and retain better executives.<sup>42</sup> Within the broad requirements of section 401(a) of the Code, private pension plans are fashioned to meet the

<sup>32</sup> *Id.* § 1002(34). Department of Labor statistics indicate that there were 250,000 defined contribution plans in operation during 1974. 120 CONG. REC. 16552-53 (daily ed. Sept. 12, 1974).

<sup>33</sup> 29 U.S.C.A. § 1002(35). There were 100,000 defined benefit plans in existence in 1974. 120 CONG. REC. 16553 (daily ed. Sept. 12, 1974).

<sup>34</sup> 29 U.S.C.A. § 1002(34).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* § 1002(35).

<sup>37</sup> *Id.* §§ 1081-86.

<sup>38</sup> See Pension Reform Act, U.S. Code Cong. & Ad. News, No. 8A, at 290 (Sept. 20, 1974). Private pension coverage is not universal. Although coverage is impressive in the industrial labor force, surveys within the last decade indicate that approximately half of the nonagricultural work-force does not now participate in pensions. Rolnick, *Public Policy with Respect to Vesting and Funding of Private Pension Plans*, in N.Y.U. TWENTIETH ANNUAL CONFERENCE ON LABOR, 369, 371 (1968); H.R. REP. NO. 93-779, 93d Cong., 2d Sess. 3, 11 (1974). Furthermore, many industrial firms still do not have retirement programs and in those which do, not all employees are participants. See HOUSE WAYS AND MEANS COMMITTEE, PANEL DISCUSSIONS ON GENERAL TAX REFORM, 93d Cong., 1st Sess. 1130 (1973) (remarks of Prof. Daniel Halperin).

<sup>39</sup> SUBCOMM. ON LABOR OF THE SENATE COMM. ON LABOR AND PUBLIC WELFARE, STATISTICAL ANALYSIS OF MAJOR CHARACTERISTICS OF PRIVATE PENSION PLANS, 92d Cong., 2d Sess. 31 (1972) [hereinafter STATISTICAL ANALYSIS].

<sup>40</sup> See text at notes 115-23 *infra*.

<sup>41</sup> As of June, 1970, only 34,000 plans were on file with the Department of Labor. STATISTICAL ANALYSIS, *supra* note 39, at 1.

<sup>42</sup> Cf. Note, *Pension Plans and the Rights of the Retired Worker*, 70 COLUM. L. REV. 909, 917 (1970) [hereinafter *Retired Worker*]. An employer may also secure other advantages by providing a pension fund, e.g., longevity of service not otherwise assured the employer and easier retirement and replacement of super-annuated employees. *Id.*

needs and resources of each particular employment relationship. The employer determines not only how much he or she is willing and able to contribute toward a pension plan, but also whether the plan should be contributory or non-contributory. The employer also decides upon the coverage and benefits of the plan and chooses between alternative funding agencies. This flexibility in design and the variability of financial and industrial needs have generated a vast array of pension plan arrangements.

Pension plans may be organized on either a multi-employer or a single-employer basis.<sup>43</sup> Under multi-employer plans,<sup>44</sup> a common rate of contribution is established for all participating employers, and a single pooled fund is created which in turn disburses benefits to all employees covered by the plan.<sup>45</sup> Participating employers generally benefit from a reduction in costs due to economies of scale. Where multi-employer plans are subject to the provisions of the Taft-Hartley Act, which is usually the case in plans negotiated through collective bargaining,<sup>46</sup> a joint board of trustees manages the pension trust.<sup>47</sup> In such cases, the potential for overreaching and self-dealing by the employer in the administration of the pension plan is greatly reduced. Moreover, the structural characteristics of the multi-employer mechanism make it unlikely that employee pension benefits will be destroyed by the business failure of any single employer.<sup>48</sup> In fact, "[the sole] vulnerable feature of the pooled fund is in a formula of financing . . . which, in effect, ties contributions to the aggregate level of employment . . . ."<sup>49</sup> In this respect, the plan does create a great deal of uncertainty concerning the benefit levels which a pooled fund can support. Nevertheless, the negligible incidence of benefit loss in the operation of multi-employer plans<sup>50</sup> and the participation of

<sup>43</sup> D. MCGILL, *FUNDAMENTALS OF PRIVATE PENSIONS* 52 (2d ed. 1964).

<sup>44</sup> A multi-employer plan is defined as a plan which covers the employees of two or more financially unrelated employers. *TERMINATIONS*, *supra* note 2, at 66.

<sup>45</sup> See S. REP. NO. 1734, 84th Cong., 1st Sess. 15 (1956). These so-called "fixed-contribution" plans prescribe employer contributions based on a specific formula, e.g., a percentage of payroll or cents per man-hour. *Id.* See also Isaacson, *Employee Welfare and Pension Plans: Regulation and Protection of Employee Rights*, 59 COLUM. L. REV. 96, 100 (1959). Benefits payable to participants are generally formulated from time to time by the trustees, usually with the advice of actuaries. *Cf. id.* at 101.

<sup>46</sup> See Goetz, *Developing Federal Labor Law of Welfare and Pension Plans*, 55 CORNELL L. REV. 911(1970); Levin, *supra* note 14, at 528; *Retired Worker*, *supra* note 42, at 919, 921. For a detailed discussion of the scope and nature of the bargaining obligation, see Goetz, *Pension Plans and Labor Law*, 1967 U. ILL. L.F. 738.

<sup>47</sup> *Retired Worker*, *supra* note 42, at 909. See also S. REP. NO. 1734, 84th Cong., 1st Sess. 15 (1956).

<sup>48</sup> See Tilove, *Multi-Employer Pension Plans*, in N.Y.U. SEVENTH ANNUAL CONFERENCE ON LABOR 639, 649-50 (1954).

<sup>49</sup> Barbash, *The Structure and Evolution of Union Interests in Pensions*, in STAFF OF SUBCOMM. ON FISCAL POLICY OF THE JOINT ECONOMIC COMM., OLD AGE INCOME ASSURANCE: A COMPENDIUM OF PAPERS ON PROBLEMS AND POLICY ISSUES IN THE PUBLIC AND PRIVATE PENSION SYSTEM, 90th Cong., 1st Sess., pt. IV 60, 81, (Comm. Print 1967).

<sup>50</sup> Between 1965 and 1971 only 674 employees covered by only 5 plans lost benefits. This represented less than .01% of the total number of participants in all multi-



union representatives in the investment of funds and the distribution of benefits generally make these pension arrangements economically stable and, as such, poor examples of the risks and abuses presently under examination.

Single-employer plans,<sup>51</sup> especially where unilaterally established, better illustrate the threats to retirement security which inhere in the current operation of private pension plans. The employer's discretion regarding the management of trust assets is greatest under these plans.<sup>52</sup> To be sure, as the proportion of collectively bargained plans increases, employee representatives will intensify their demands for a greater voice in the administration of pension plans, and the risks of employer self-dealing will diminish. Yet even where the plans are so negotiated, there is "considerable evidence" that the administrative problems inherent in pension plan administration may convince some unions to permit management to control the plans and the investment of the pension funds.<sup>53</sup>

One aspect of pension plans which is shaped by the Code is the use of a funding agency distinct from the employing firm. This separate agency is mandatory under the Code before the employer may qualify for the tax advantages of maintaining a pension plan.<sup>54</sup> Funding typically occurs either through the purchase of an annuity contract from an insurance company or through the establishment of a trust.<sup>55</sup> In trust-funded plans, the trust receives contributions which are invested in securities and other assets.<sup>56</sup> Management has favored these plans because of their numerous cost advantages. One such advantage is that under a trustee plan, investment income, which reduces contributions necessary to fund defined benefits,<sup>57</sup> is potentially higher because pension law limits on investments in common stock are less restrictive than state laws governing insurance companies.<sup>58</sup>

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employer plans in 1971. *TERMINATIONS*, *supra* note 2, at 3-4.

<sup>51</sup> Single-employer plans represent three-quarters of all private pension plans. *STATISTICAL ANALYSIS*, *supra* note 39, at 31.

<sup>52</sup> In 1971, nearly 90 percent of all single-employer plans were employer-administered. *TERMINATIONS*, *supra* note 2, at 67-68.

<sup>53</sup> Barbash, *supra* note 49, at 88.

<sup>54</sup> INT. REV. CODE OF 1954, § 401(a).

<sup>55</sup> Cf. S. REP. NO. 1734, 84th Cong., 2d Sess. 48-49 (1956). See also Kearshes, *Methods of Funding in Pension Planning: The Trustee Plan*, in N.Y.U. TENTH ANNUAL CONFERENCE ON LABOR 205, 207-08 (1957).

<sup>56</sup> *Id.*

<sup>57</sup> Kearshes, *supra* note 55, at 214. In an ordinary trust-funded pension plan, current contributions will be greater than currently payable benefits for a number of years. Excess contributions are required to be invested in safe but productive assets, and earnings on investments serve to reduce the present cost to the employer of future benefits. *Id.* Interest earned on investment is one of the actuarial assumptions included in the cost formula used to determine a fixed rate of yearly contributions. Melnikoff, *Actuarial Bases: The Interest Rate*, in N.Y.U. TENTH ANNUAL CONFERENCE ON LABOR 85, 90, 91 (1957).

<sup>58</sup> See J. MELONE & E. ALLEN, JR., *PENSION PLANNING* 233 (1966) [hereinafter cited as MELONE & ALLEN] See also Kearshes, *supra* note 55, at 214-18. It should be noted,

Moreover, initial costs are lower, and the avoidance of certain administrative costs included in insurance premiums makes the trust plan less onerous in the early years.<sup>59</sup>

Trusteed plans, however, are particularly vulnerable to the self-interested biases of the sponsoring employers. Although trustees of such plans are normally banks having trust powers,<sup>60</sup> there is no legal obligation that the trustee be a corporate entity unrelated to the company of the sponsoring employer.<sup>61</sup> Thus, there is nothing to prevent the employer himself from serving as trustee of the plan. Even where banks do serve as trustees, there is no legal requirement that the trustee-bank have unlimited or sole discretion with respect to the investment of funds.<sup>62</sup> This again creates a potential for employer influence in the management of pension funds. Trust-funded plans, therefore, suffer from disadvantages rare in insured plans—the possibility of loss from risky investments and of inadequate funding due to over optimistic actuarial assumptions on the part of sponsoring employers.

Two-thirds of all private pension plans, covering about 75 percent of all participating employees, are self-administered.<sup>63</sup> In such cases, a bank typically holds the funds as trustee and the sponsoring employer administers their investment in accordance with broad discretion granted under the trust agreement.<sup>64</sup> A trust company or other corporate trustee is often appointed to accept legal title since these institutions are generally more experienced with the intricate requirements of the Code and the disclosure and fiduciary laws.<sup>65</sup> In the case of unilateral plans—those which are initiated by the company—employer-appointed committees generally control trust investment policies.<sup>66</sup> Although the employer may consult professional investment advisors, it is unlikely that any arrangement will be as satisfactory to the employer as a corporate trustee and an investment committee of company officers.<sup>67</sup> Similarly, even where plans are initiated through negotiation with the union, employers almost universally aim to prevent unions from participating in the investment of

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however, that insurance companies, in an effort to retain a competitive position in the pension field, have successfully obtained legislative authority in a large number of states to segregate assets held in connection with pension plans and to invest those assets in common stocks. *Id.* See also 1 CCH PENSION PLAN GUIDE ¶ 719 at 2078-79 (1975).

<sup>59</sup> E. BEAL, E. WICKERSHAM & P. KIENAST, *THE PRACTICE OF COLLECTIVE BARGAINING* 419 (1972). See also Kearshe, *supra* note 55, at 213-14.

<sup>60</sup> Kearshe, *supra* note 55, at 209.

<sup>61</sup> INT. REV. CODE of 1954, § 401(a).

<sup>62</sup> *Id.* § 401(a).

<sup>63</sup> STATISTICAL ANALYSIS, *supra* note 39, at 31.

<sup>64</sup> See *Retired Worker*, *supra* note 42, at 909; 917-18; cf. Kearshe, *supra* note 55, at 209.

<sup>65</sup> Kearshe, *supra* note 55, at 209, 210.

<sup>66</sup> See 1 CCH PENSION PLAN GUIDE ¶ 1062 (1975).

<sup>67</sup> Note, 78 HARV. L. REV. 1230, 1231-32 (1965).

pension reserves and, in most cases, have succeeded in doing so.<sup>68</sup> In fact, management's own argument for withholding power over investment of pension funds from the union is that these funds ought to be placed beyond the political control of the union and that the principal ought to be protected from unwise speculation in union hands.<sup>69</sup>

Employer-managed pension plans thus possess a potential for conflicts of interest due to the degree of employer control over the investment of pension funds. The problem is greatest in unilaterally established pension plans, where the tendency toward financial integration of the concerns of the plan and those of the company is unavoidable.<sup>70</sup> The lack of adequate supervision due to the absence of the contractual restraints of collective bargaining frees an employer to approach his investment responsibilities in a far less conservative manner. Moreover, pension trust instruments which generally authorize broad investment discretion on the part of the trustee accommodate, if they do not actually encourage, a degree of laxity in funding discipline which may adversely affect the benefit expectations of the participants by later causing financial difficulties for the plan.

The increasing costs of pension plans inevitably influences employer decisions in the investment of pension funds. Choice of the funding agency, determination of the annual contribution rates, investment of pension fund assets, and actuarial assumptions, where dependent upon the fluctuating financial condition of the employer, inevitably reflect the changing needs of the sponsoring company to reduce its expenses. Indeed, the efforts of investment managers to minimize the costs of pension plans for their sponsoring employers appears to be the crux of the problem of pension plan security.<sup>71</sup> Excessive risk-taking in the investment policies of employer-managed funds inevitably endangers pension benefits in a manner unperceived by the beneficiaries of the plan. Employees regard pensions as an insurance mechanism, and although they often challenge the adequacy

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<sup>68</sup> James, *Manipulation of a Joint Pension Board for Power Purposes: The Teamster Experience*, in N.Y.U. TWENTIETH ANNUAL CONFERENCE ON LABOR 381, 390 (1968).

One author states that a union's right to control the investment of pension funds is not at all certain where the competing ownership claims to the funds, in themselves, are subject to doubt. Harbrecht, *Union Participation in the Investment of Pension Funds*, in N.Y.U. FOURTEENTH ANNUAL CONFERENCE ON LABOR 385, 386 (1961). He adds that the union does have a legitimate right to bargain over investment policy. *Id.*

<sup>69</sup> It appears, however, that union participation on trustee boards, where it does exist, exerts a highly conservative influence. Harbrecht, *supra* note 68, at 391. Union leaders often insist that funds be placed in government bonds or government insured mortgages in order to secure the principal. *Id.*

<sup>70</sup> See STATISTICAL ANALYSIS, *supra* note 39, at 31.

<sup>71</sup> "Pension fund managers need to be concerned with earning an adequate return on pension fund assets, since high return reduces the cost of a dollar's worth of pension payments." *Investment Policies*, *supra* note 28, at 152. In quantitative terms, it has been noted that "a one percent difference in yield earned on pension fund assets means roughly a 20-25% difference in ability to pay benefits, or in the employer's cost of paying them." *Id.* at 123, citing M. Bernstein, *THE FUTURE OF PRIVATE PENSIONS* 41 (1964).

of benefits under the plan, they rarely question the ultimate existence of those benefits. Such reliance may be misplaced.<sup>72</sup>

The speculative trend in pension fund investment, evidenced by increasing proportions of common stock ownership, has been in response to the steady increase in the cost of retirement programs and the concurrent institutionalization of private pension plans in the employment context.<sup>73</sup> Initially, the restricted size and scope of non-insured plans guided their investment along traditional trust lines.<sup>74</sup> Thus, pension funds were customarily invested in publicly-issued, high-quality bonds.<sup>75</sup> Moreover, industrial companies would frequently include restrictions in their pension trust agreements which limited the investment of pension funds to those securities in which life insurance companies or trust fiduciaries under New York law were legally authorized to invest.<sup>76</sup> However, in the late 1940's, with government bond yields pegged at 2 percent, equities became more attractive for current income.<sup>77</sup> The post-war easing of restrictions on insurance companies and savings banks facilitated analogous changes in the trust laws and made it possible for trust fiduciaries to invest substantial proportions of trust portfolios in equity securities.<sup>78</sup>

Qualitative changes in pension fund investment policy occurred gradually, following the growth in pension fund assets and the mounting costs of retirement benefits. Total estimated assets of pension plans grew from \$2.4 billion in 1940 to more than \$150 billion in 1973, and accumulations are projected to exceed \$250 billion by 1980.<sup>79</sup> Originally content to invest their capital in relatively safe, low-return investments, pension fund managers became more and more willing by the late 1950's to take higher risks in the expectation of larger returns.<sup>80</sup> As it became increasingly clear that a company creating a pension plan was funding a future income benefit—one necessarily determined by a standard of living which the employee would be enjoying at the time of retirement—companies had to adjust

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<sup>72</sup> See *Investment Policies*, *supra* note 28, at 27: "I believe there are serious dangers if people seeking retirement income are led to believe that investments in common stocks are essentially equivalent to fixed income securities, but simply offer a much higher rate of return."

<sup>73</sup> This historical summary of pension fund investment policies relies on a more detailed and comprehensive account by Murray, *Economic Aspects of Pensions: A Summary Report*, in STAFF OF SUBCOMM. ON FISCAL POLICY OF THE JOINT ECONOMIC COMMITTEE, OLD AGE INCOME ASSURANCE: A COMPENDIUM OF PAPERS ON PROBLEMS AND POLICY ISSUES IN THE PUBLIC AND PRIVATE PENSION SYSTEM, 90th Cong., 1st Sess., pt. 5, at 82 (Comm. Print 1967).

<sup>74</sup> *Id.* at 81.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* at 82.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> S. REP. NO. 127, 93d Cong., 1st Sess. 5 (1973).

<sup>80</sup> Cf. *Investment Policies*, *supra* note 28, at 142: "The traditional investments of pension funds—bonds and mortgages—have not been able to keep up in performance with alternative investments in equities during prolonged periods of inflation."

from the concept of satisfying a fixed commitment to one of satisfying not only commitments already made but also others likely to arise in the future.<sup>81</sup> Hence, substantial emphasis on pension fund performance developed, which increased the role of equity in pension portfolios.

It may be true that "[n]otwithstanding [the] risk, intelligent investment in common stocks provides a means by which a trustee can maintain the purchasing power of a trust estate and participate in general economic growth."<sup>82</sup> Nevertheless, risk considerations are not so easily dismissed. If, as one author suggests, "[i]t is safe to conclude that the activities of corporate trustees are directed solely toward obtaining the maximum return on the funds entrusted to them consistent with a high degree of risk, [while] adhering to the rule that the trustee is primarily a conservator . . .,"<sup>83</sup> it seems but a short step in a unilaterally established, self-administered plan to adopt an aggressive, performance-oriented investment policy in which evaluations of risk are all but absent. The extreme example would be the investment by an employer-manager of the bulk of pension fund assets in his own securities. Doubtless such manifest self-dealing would be prevented, even by the coarse web of legal constraints which currently exists.<sup>84</sup> Less blatant, but equally threatening to retirement expectations, is the investment by an employer-manager of the bulk of the portfolio in high-risk, high-return equity securities. Such investments might seem reasonable from the perspective of an employer attempting to reduce costs through the investment return on the fund. This is especially true in light of the fact that if a pension plan fails to the extent that it cannot meet its pension commitments, the employees, rather than the employer, bear the loss.<sup>85</sup> On the other hand, the quality of an in-

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<sup>81</sup> Pension plans are often amended to increase accrued benefits payable on retirement and to adjust benefit formulas prospectively to reflect inflationary movements and changes in the cost of living. See Goldstein, *Inflation and Deflation in Pension Planning*, in N.Y.U. TENTH ANNUAL CONFERENCE ON LABOR 223, 229-30 (1957). Moreover, many benefit formulas are initially based on the retiring employee's monthly income just prior to retirement. *Id.* at 228-29. The impact of this "escalation effect," namely, the need to increase future benefits due to inflation, is most severe under plans in which benefits are based on the final earnings of the employee. *Investment Policies*, *supra* note 28, at 155. In this situation, an employee's benefits, paid with regard to his work for perhaps 40 years, depend upon his salary level between the ages of 60 and 65. *Id.* While actuaries are capable of predicting an average employee's salary advancement, it is almost impossible to predict general salary levels 40 years into the future. *Id.* For a discussion of the advantages and disadvantages of these provisions, which are often called "final-pay" provisions, see Melone, *supra* note 58, at 34-35.

<sup>82</sup> Note, *Common Stocks in Trust*, 113 U. PENN. L. REV. 228, 230 (1964).

<sup>83</sup> P. HARBRECHT, *PENSION FUNDS AND ECONOMIC POWER* 101 (1959).

<sup>84</sup> Cf. 2 A SCOTT, *THE LAW OF TRUSTS* § 170.15, at 1339-41 (3d ed. 1967).

<sup>85</sup> [T]he quest for high yield is attended, as always, by commensurate risks. The price of failure can be a fund's [inability] to meet its pension commitments—a loss presumably to be borne not by administrators or money managers but by beneficiaries who share the losses and not the gains.

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vestment to the beneficiary is a function of profitability *discounted* by risk. This situation clearly suggests that a beneficiary's interest, where retirement security is at stake, is inadequately protected.

### II. PENSION PLAN REGULATION PRIOR TO ERISA

Before examining in detail the conflict of interest problems inherent in employer management of pension funds, and the limits of the system of disclosure coupled with a fiduciary standard established in the Employee Retirement Security Act of 1974,<sup>86</sup> it is useful to examine the state and federal regulations which governed the investment of pension funds prior to passage of the Act.

#### A. Internal Revenue Code of 1954

Prior to the enactment of ERISA, the Code exerted indirect control over pension funds by granting tax benefits to funds that complied with conditions specified in section 401(a) of the Code. Because the Code provisions were not repealed by ERISA, these tax benefits are still available. If a pension plan qualifies under the Code, the employer can deduct contributions to the plan as ordinary and necessary business expenses at the time the contributions are made.<sup>87</sup> Moreover, employer contributions are not includable in the taxable income of participating employees until actually received,<sup>88</sup> and in some cases benefit distributions will be taxed to the employees at capital gains rates.<sup>89</sup> Finally, investment earnings on funds accumulated under trust-funded plans are exempt from taxation<sup>90</sup> unless they constitute "unrelated business income."<sup>91</sup>

To qualify for this preferential tax treatment, the plan is required to meet all of the conditions specified in section 401(a). The plan has to be written,<sup>92</sup> permanent, and intended for the exclusive benefit of employees and their beneficiaries.<sup>93</sup> It cannot be possible under the trust agreement for any part of corpus or income to be di-

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*Joint Economic Committee*, 91st Cong., 2d Sess. 136 (1970) [hereinafter cited as *Investment Policies*]. See text at notes 180 & 182 *infra*.

<sup>86</sup> 29 U.S.C.A. §§ 1021-31, 1104-14 (1975).

<sup>87</sup> INT. REV. CODE OF 1954, § 404(a)(1).

<sup>88</sup> *Id.* § 402(a)(1).

<sup>89</sup> *Id.* §§ 402(a)(2), 402(a)(5). Basically, lump sum distributions of benefits payable to the employee, if made within one year of the employee's death or other "separation from . . . service," are taxable at capital gains rates to the extent that the amount of such distributions exceeds the employee's own contributions.

<sup>90</sup> *Id.* § 501(a).

<sup>91</sup> *Id.* § 501(b). "Unrelated business income" is defined in §§ 512 and 513(b) of the Code. Generally, income derived from any "trade or business" regularly carried on by a pension trust exempt under § 401 will be deemed unrelated business income and will be taxable under § 511.

<sup>92</sup> *Id.* § 401(a).

<sup>93</sup> *Id.* § 401(a)(2).

verted to any other use prior to the satisfaction of employee claims.<sup>94</sup> The plan cannot discriminate in favor of highly-compensated employees, officers, stockholders, or supervisory personnel,<sup>95</sup> and it is required to benefit a minimum percentage of all employees.<sup>96</sup> The plan is also required to guarantee certain non-forfeitable benefits in the event of termination, and to provide that upon termination or upon complete discontinuance of contributions, participating employees will have immediate vested rights to benefits which are accrued and funded.<sup>97</sup> Finally, the pension plan is required to provide that benefits will be determinable and that forfeitures will not be applied to increase the benefits which any remaining employees would otherwise receive under the plan.<sup>98</sup>

The Code, however, does not attempt to dictate the manner in which pension funds should be invested. No specific limitations are set forth in section 401(a) with respect to investments which can be made by the trustee of a qualifying trust. Generally, contributions can be used by the trustee to purchase any investments permitted by the trust agreement to the extent allowed under local law.<sup>99</sup> This broad license is narrowed only by the requirement, provided in section 401(a)(2) of the Code, that trust funds be used solely for the exclusive benefit of the employees and their beneficiaries.<sup>100</sup> The Service has indicated that an investment will generally satisfy the "exclusive benefit" requirement if the following standards are met: (1) the cost of the investment must not exceed its fair market value at the time of purchase; (2) the investment must provide a fair return commensurate with the prevailing rate; (3) sufficient equity must be maintained to permit distribution in accordance with the terms of the plan; and (4) the safeguards and diversity that a prudent investor would adhere to must be present.<sup>101</sup>

These standards, however, have proved to be unenforceable, except in the most flagrant instances of abuse. An example of such flagrant abuse arose in Rev. Rul. 73-532 where the Service was presented with an employees' trust agreement which provided the trustee with "complete power to invest trust funds without regard to whether investments may be new, speculative, hazardous, adventurous, or productive of income."<sup>102</sup> The Service held that the trust was not designed for the "exclusive benefit of the employees" and thus did not qualify under section 401(a).<sup>103</sup> However, in the great majority of

<sup>94</sup> *Id.*

<sup>95</sup> *Id.* § 401(a)(4).

<sup>96</sup> *Id.* § 401(a)(3).

<sup>97</sup> *Id.* § 401(a)(7).

<sup>98</sup> *Id.* § 401(a)(8).

<sup>99</sup> Treas. Reg. § 1.401-1(b)(5)i (1972).

<sup>100</sup> INT. REV. CODE OF 1954, § 401(a)(2).

<sup>101</sup> Rev. Rul. 73-380, 1973-2 Cum. Bull. 124, 125; Rev. Rul. 69-494, 1969-2 Cum. Bull. 88. See also IRS PUBLICATION 778 (1972).

<sup>102</sup> Rev. Rul. 73-532, 1973-2 Cum. Bull. 128.

<sup>103</sup> *Id.* at 129.

cases, where the terms of the trust are more reasonable and the investment behavior of the trustee less extreme, the Service has been reluctant to enforce sanctions against plans in questionable compliance with the standards.<sup>104</sup> This reluctance is due to the fact that under the Code, the only sanction for breach of this fiduciary standard is disqualification of the entire plan.<sup>105</sup> Even where the trustee has engaged in transactions specifically prohibited under the Code,<sup>106</sup> the Service has been unwilling to revoke the trust's tax exemption because of the sudden and drastic effect that such a sanction would have upon the employees.<sup>107</sup> Clearly, departure from the general investment guidelines offers no greater reason for revoking qualification. In any event, it is unlikely that sporadic IRS audits of trust investments would serve as adequate enforcement, even if the standards were enforced.

In addition, the "exclusive benefit rule" conflicts with a feature inherent in the operation of pension plans: a fiduciary who successfully invests pension funds benefits both the employer and the employees. The income earned on trust investments does not redound to the exclusive benefit of the employees, and the Code has never been read so literally as to require such a result. The Service has stated that the rule "does not prevent others also drawing some benefit from a transaction with the trust" and that it is the "*primary purpose* of benefiting employees" which must be maintained with respect to investments.<sup>108</sup> Thus modified, the section 401(a)(2) standard establishes a test of fiduciary responsibility no more rigorous than that which already existed under the prudent man standard. As a practical matter, the threat of disqualification for imprudent investments has exerted only slight influence on pension investment policy.<sup>109</sup>

Furthermore, it is at least arguable that two deficiencies in the Code's funding requirements have encouraged an illusory security and a misplaced reliance on the part of employees. Originally, pension funds were established as balance sheet reserves on the books of sponsoring employers; benefits were expensed as they fell due and no current provision was made for future costs.<sup>110</sup> The Code, however, contemplates an advance funding process, designed so that accumu-

<sup>104</sup> See, e.g., Rev. Rul. 69-65, 1969-1 Cum. Bull. 114, 115. See also Pension Reform Act, U.S. Code Cong. & Ad. News, No. 8A, at 596 (Sept. 20, 1974).

<sup>105</sup> See Note, 88 HARV. L. REV. 960, 960-61 (1975).

<sup>106</sup> See INT. REV. CODE OF 1954, § 503.

<sup>107</sup> Because of the conduct of an employer and trustee, an employee, upon disqualification of the trust, may have to pay a tax on contributions made on his behalf long before he receives them. This possible disadvantage to innocent employees has inspired Service reluctance to impose the sanctions. See S. REP. NO. 383, 93d Cong., 1st Sess. 18 (1973).

<sup>108</sup> Rev. Rul. 73-380, 1973-72 Cum. Bull. 124, 125; Rev. Rul. 69-494, 1969-2 Cum. Bull. 88 (emphasis added).

<sup>109</sup> See Hearings on H.R. 5741 Before the Subcomm. on Ed. & Labor of the House Committee on Ed. & Labor, 90th Cong., 2d Sess. at 54 (1968) (remarks of Sen. Javits).

<sup>110</sup> P. HARBRECHT, PENSION FUNDS AND ECONOMIC POWER 6 (1959).



lated assets will equal all accrued liabilities after a specified period of time.<sup>111</sup> While full and immediate funding of all accrued liabilities is financially the most conservative approach, it requires relatively large contributions when a plan is first put into operation.<sup>112</sup> An alternative and more typical funding process is that which strives to achieve full funding over the period of time during which the plan will presumably be in continuing operation. The ultimate cost of the plan under this scheme amounts to the sum of the benefits actually paid and the cost of administering the plan, less income earned on the accumulated assets during the funding period.<sup>113</sup> Although this process offers less certainty of benefits, it is also less costly in the early stages.

To be deductible under section 404(a) of the Code, pension fund contributions must also be "reasonable."<sup>114</sup> Deductibility under section 404(a) is triggered by initial compliance with the requirements of either section 162 (trade or business expense) or section 212 (production of income expense), although deductions prohibited by the terms of section 404(a) may not be permitted under any other Code provision.<sup>115</sup> Section 404(a) establishes limits for maximum deductions rather than standards for minimum contributions. These maximum deduction limits are designed to curtail manipulation of the tax benefit to employers in years of high income.<sup>116</sup> While these limits implicitly define employer contributions deemed necessary to fund pension benefits, minimum funding requirements themselves are not explicitly set forth in the Code.

Instead, standards of reasonable funding are nestled in rulings and regulations concerning disqualification of plans by virtue of termination.<sup>117</sup> Under these standards, termination of a pension plan will ordinarily occur upon the complete discontinuance of the employer's contributions.<sup>118</sup> Where, however, contributions to a qualified plan are sufficient to pay the liabilities created currently (the "normal costs" of pension payments) as well as the interest due on un-

<sup>111</sup> See INT. REV. CODE OF 1954, § 404(a)(1)(A).

<sup>112</sup> While benefits earned after inception of a plan may be funded as they accrue, a substantial unfunded liability is often created when the plan is initiated by granting employees either full or partial credit for earlier service. DEPARTMENT OF THE TREASURY AND DEPARTMENT OF LABOR, STUDY OF PENSION PLAN TERMINATIONS, 1972: FINAL REPORT 34 (1973) [hereinafter TERMINATIONS]; Beier, *Terminations of Pension Plans: Eleven Years' Experience*, 90 MONTHLY LABOR REV. 26, 28 (June, 1967).

<sup>113</sup> Tilove, *The Organization of a Pension Plan*, in N.Y.U. TENTH ANNUAL CONFERENCE ON LABOR 55, 71-72 (1957).

<sup>114</sup> In no case is a deduction allowable under section 404(a) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered.

Treas. Reg. § 1.404(a)-1(a)(4)(b).

<sup>115</sup> See Pension Reform Act, U.S. Code Cong. & Ad. News, No. 8A, at 399 (Sept. 20, 1974).

<sup>117</sup> See, e.g., Treas. Reg. § 1.401-6(c).

<sup>118</sup> See Treas. Reg. § 1.401-6(b)(1),(2).

funded accrued liabilities (the "past service costs" of pension payments),<sup>119</sup> an employer's suspension of contributions will not constitute a discontinuance and the plan will retain its qualification.<sup>120</sup> In some cases, "[a] complete discontinuance of contributions may occur although some amounts are contributed by the employer if such amounts are not substantial enough to reflect the intent on the part of the employer to continue to maintain the plan."<sup>121</sup> While obliquely mandating a minimum contribution schedule, this standard offers little certainty that promised benefits are in fact adequately funded. The requirement of contributions tends to keep the amount of unfunded liabilities from growing larger. Nevertheless, there is no legal compulsion to amortize the principal amount. This deficiency in itself poses a serious threat to the retirement security of elderly employees, many of whose service credits accrued prior to the establishment of the plan.

More significant from the perspective of trustee investment prerogative is the absence of any explicit requirement that an employer increase his or her current contributions to reflect investment losses ("experience losses"). Revenue Bulletin 57-550<sup>122</sup> specifically permits the relegation of such losses to "past service costs."<sup>123</sup> This license effectively enables the employer to shift the risk of loss on all trust investments to the employees, and leads to the conclusion that considerations of tax avoidance and not of adequate funding motivated the establishment of the Code's scattered funding standards.

### B. Trust Law

While the preferential treatment afforded under section 401 of the Code to qualifying pension trusts exerted indirect control over pension funds, the creation and administration of trustee plans remained subject to the state law of trusts. A trust is defined as a fiduciary relationship in which a trustee holds legal title to property subject to the equitable obligation to conserve the principal for the benefit of the trust's beneficiaries.<sup>124</sup> The duties of the pension plan trustee depend primarily on the terms of the trust,<sup>125</sup> and these are ordinarily enforceable in a court of equity.<sup>126</sup> Where the trust instrument is silent, state statutory provisions and case law govern the

<sup>119</sup> Treas. Reg. § 1.401-6(c)(2)(ii). See also *IRS Guides on Plan Termination*, IRS PUBLICATION 778, Part 6(d)(1) (1972).

<sup>120</sup> Treas. Reg. § 1.401-6(c). "Unfunded accrued liabilities" result from service credits attaching to services performed prior to the establishment of the plan. See note 112 *supra*. They also include the value of any future benefits, attributable to adjustments in the coverage and benefit structure of the plan, which relate to such past service.

<sup>121</sup> Treas. Reg. § 1.401-6(c)(1).

<sup>122</sup> Rev. Rul. 57-550, 1957-2 Cum. Bull. 266.

<sup>123</sup> *Id.* at 267.

<sup>124</sup> 1 A. SCOTT, *supra* note 84, § 2.3, at 37-38.

<sup>125</sup> 1 *id.* § 4, at 46; 2 *id.* § 164, at 1254; 2 *id.* § 164.1, at 1257.

<sup>126</sup> 1 *id.* § 2.7, at 43.

trustee's rights and responsibilities.<sup>127</sup>

The general rule is that where the trust assets cannot be applied immediately or within a short time to the purposes of the trust, the trustee is authorized and obliged to make the fund productive by proper investments.<sup>128</sup> Investment of pension fund assets therefore existed under general trust principles as an affirmative responsibility of the trustee. Although it is commonly understood that a trustee must make the fund productive without improperly risking loss of the principal,<sup>129</sup> trust law reveals a long-standing ambivalence concerning the standard of sound discretion against which a trustee's investments are to be measured.<sup>130</sup>

Parallel standards—one narrow and unequivocal, the other flexible and ill-defined—reflect the historical tension in trust law between a desire for certainty and a need for discretion. Under the narrow standard, a trustee may safely invest in the types of investments or the classes of securities designated by a state statute, unless the trust instrument contains prohibitions to the contrary.<sup>131</sup> The avowed purpose of this standard is to protect against dissipation of the trust property through the trustee's imprudent investments.<sup>132</sup> Implicit in such a statutory scheme is the legislative judgment that only certain thresholds of risk and return are appropriate where individuals invest assets which are not their own. Where states articulate such a list of legal investments, a trustee's fiduciary responsibilities are easily monitored.

Most states, however, rely on statutory or common law notions of "prudence."<sup>133</sup> Generally stated, the "trustee is under a duty to make such investments as a prudent man would make of his own property having primarily in view the preservation of the estate and the amount and regularity of the income to be derived."<sup>134</sup> Although the prudent man rule purports to be a detached and objective standard, the variety of state constructions and the ambiguity of their application in particular instances demonstrate the fundamental obscurity of the concept of prudence, except in those cases where the trustee's conduct borders on outright negligence.<sup>135</sup>

<sup>127</sup> 2 *id.* § 164, at 1254-57; 3 *id.* § 186, at 1499.

<sup>128</sup> 2 *id.* § 181, at 1463; *see, e.g.,* Levin v. Commissioner, 355 F.2d 987 (5th Cir. 1966).

<sup>129</sup> 3 A. SCOTT, *supra* note 84, § 277, at 1805.

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> *In re Michaelson*, 162 Misc. 847, 851, 296 N.Y.S. 119, 124-25 (Sup. Ct. 1937).

<sup>133</sup> 3 A. SCOTT, *supra* note 84, § 227, at 1805-06.

<sup>134</sup> *Id.*

<sup>135</sup> The prudent man rule was first articulated by Judge Putnam in *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830), in the following words:

All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposi-

Pension trust indentures generally grant the trustee broad discretion in his choice of investments, subject to this requirement of prudence. Even where the trustee's discretion is unqualified, a rule of prudence has been inferred unless expressly negated by the terms of the trust.<sup>136</sup> Pension managers themselves claim to perceive the prudent man rule as a formal restriction on their investment policy.<sup>137</sup> Furthermore, even in those states which have adopted a statutory list of permissible investments, an operative limiting principle of prudence is reflected.<sup>138</sup> Despite such widespread agreement on the role of prudence, its translation into a functional standard balancing risk and return has been inadequate. Doctrinally, a trustee must exercise the caution in making investments which characterizes a prudent man who is investing the money of someone else.<sup>139</sup> Such a standard attempts to preclude the adventurous leanings often exhibited by people, however reasonable, when investing their own property. So long as risk remains unmeasurable, however, the standard remains unenforceable except in cases of flagrant abuse.

The scarcity of reported cases in which the trustees of employee benefit trusts have been held liable for imprudent investments attests, in part, to the unenforceable vagaries inherent in such a standard. Most of the cases which have involved a breach of fiduciary duties have dealt with matters other than investments, such as administrative self-dealing and improper delegation of authority.<sup>140</sup> Moreover, a

tion of their funds, considering the probable income, as well as the possible safety of the capital to be invested.

*Id.* at 461. The New York Court of Appeals, in *King v. Talbot*, 40 N.Y. 76 (1869), rephrased the rule, declaring that the trustee is bound to employ the diligence and prudence that "in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs." *Id.* at 85-86. Though the phrasing of the rule by the Massachusetts and New York courts has been quite similar, the rule has been traditionally construed more narrowly in New York. In its present statutory codification, the New York rule iterates a legal list of trust investments and provides that in addition to these a trustee may invest, at his discretion, up to 50% of the market value of the trust property in other securities, provided they satisfy the general requirements of prudence. See N.Y. ESTATES, POWERS & TRUST LAWS § 11-2.2(a)(1) (McKinney Supp. 1975).

<sup>136</sup> See *Greenhouse's Trust Estate*, 338 Pa. 144, 12 A.2d 96 (1940); *Conant v. Lansden*, 341 Ill. App. 488 (1950), *aff'd in part, rev'd in part on other grounds*, 409 Ill. 149 (1951).

<sup>137</sup> This Subcommittee finding was helpful in explaining the fact that nearly 40 percent of plans responding to a Senate Subcommittee Study indicated formal restrictions on their investment of trust assets. SUBCOMM. ON LABOR OF THE SENATE COMM. ON LABOR AND PUBLIC WELFARE, STATISTICAL ANALYSIS OF MAJOR CHARACTERISTICS OF PRIVATE PENSION PLANS, 92d Cong., 2d Sess. 31 (1972) [hereinafter STATISTICAL ANALYSIS].

<sup>138</sup> There is some question as to whether "prudence" requires diversification and thus by its nature imposes limits on a trustee's power to invest in "legal" securities. See 3 A. SCOTT, THE LAW OF TRUSTS § 228, at 1855-59 (3d ed. 1967) and cases cited therein. Such a conclusion would require that a trustee, even when investing in securities permitted by statute, act with due care and prudence to fully discharge his duty.

<sup>139</sup> *Cook's Trust Estate*, 20 Del. Ch. 123, 126 (1934).

<sup>140</sup> *Welch, Investment for and Management of Employee Benefit Trusts: Waiver and Modification of the Prudent Man Rule*, 110 TRUSTS AND ESTATES 350, 351 (1971). A recent

truly scientific means of determining levels of risks is required in order to effectively apply the prudence standard, especially if the court considers the portfolio as a whole rather than each individual security. Thus, it is not surprising that the few cases which have surcharged trustees for the decline in value of risky investments have not been able to provide any measure of an appropriate risk level.<sup>141</sup> In addition, the increasingly favorable attitude toward investment in common stock has rendered the definition of "prudent" even more elusive. Clearly, without standards by which he can judge the riskiness of his fiduciary's investments, a pension plan participant is ill-equipped to safeguard his interest in the plan's assets. Whatever the ultimate probability of achieving such a functional standard, it is apparent that state law has not succeeded. Cases of gross self-dealing time and again serve as the setting for lofty propositions regarding a trustee's risk preferences.<sup>142</sup> However, these doctrinal tenets are of little value in the day to day operations of pension fund investments.

Compounding the inability of state trust law to articulate an enforceable standard is the frequent uncertainty as to the type of pension plan arrangement to which the standard applies. The plan may not have been formally arranged as a trust. In fact, the trust may have existed only as a funding medium, predicated on a trust indenture executed between the employer and a bank. Where this is the case, some courts have tended to view the employee-beneficiary as having only contractual rights against the employer and not rights as a beneficiary of a trust.<sup>143</sup>

More inhibiting to the effective application of trust law has been the use of exculpatory clauses. Employers are generally frustrated by the limits which the prudent man rule places on the investments of unilateral, self-administered trusts. Because they often conceive themselves as benefactors, employers are naturally resistant to making their gift twice, as may happen if they are required to recoup investment losses. Hence, employers frequently insert exculpatory clauses in the trust indentures freeing themselves, as trustees, from liability for investment losses unless due to wilful misconduct.<sup>144</sup> Courts which

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case held that the trustees of a pension trust, who were also directors of the sponsoring corporation, breached their fiduciary duty by investing nearly the entire trust fund in a promissory note of the employer's company. Although the trust agreement permitted trustees to invest in unsecured notes, the court stated that the trustees were to be judged by a "prudent man" standard, and held that investment in unsecured notes of the funding corporation constituted manifest self-dealing in violation of that standard. *James Berardi v. W.T. Lane*, CCH PENSION PLAN GUIDE at 20,151 (App. Div. 1972).

<sup>141</sup> See, e.g., *Tuttle v. Gilmore*, 36 N.J. Eq. 617 (Ct. Err. & App. 1883) (trustee surcharged for investing in second mortgages which became worthless).

<sup>142</sup> See, e.g., *Appeal of Dickinson*, 152 Mass. 184, 187-88, 25 N.E. 99, 99-100 (1890).

<sup>143</sup> See, e.g., *Burns v. Winkler*, 221 Ga. 285, 288, 144 S.E.2d 337, 338-39 (1965).

<sup>144</sup> Note, *Pension Plans and the Rights of the Retired Worker*, 70 COLUM. L. REV. 909, 924 (1970) [hereinafter cited as *Retired Worker*].

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strictly interpreted trust indentures readily enforced such clauses.<sup>145</sup>

Finally, even where a cause of action for breach of trust can be established, not all states provide an adequate remedy. In some states an employee or a beneficiary of a pension plan may not have the legal standing to sue an administrator for breach of trust,<sup>146</sup> especially where the employee's rights under the plan have not vested.<sup>147</sup> Thus, even if the substantive fiduciary standard were functional, procedural obstacles would, without reform, prevent the employee from realistically enforcing his rights under the trust agreement.

### C. Section 302 of the Labor-Management Relations Act

Section 302 of the Labor-Management Relations Act<sup>148</sup> is not directly related to the administration of unilateral, employer-managed pension plans. Nevertheless, this section illustrates, in the context of joint-trustee plans, the failure of an implied federal fiduciary standard to provide effective restraints on investment management. Moreover, judicial treatment of the responsibilities created by this statute may foreshadow the judicial reaction to the standard of prudence set forth in ERISA.

Section 302 was enacted to prevent abuses of employee welfare funds by union officials.<sup>149</sup> The section provides that these funds must be jointly administered by the employer and the employees.<sup>150</sup>

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<sup>145</sup> See, e.g., *Collins v. Storer Broadcasting Co.*, 217 Ga. 41, 49-50, 120 S.E.2d 764, 769-70 (1961).

<sup>146</sup> See, e.g., *Whitley v. Mammoth Life & Accident Ins. Co.*, 273 S.W.2d 42, 43 (Ky. 1954). See also *Retired Worker*, *supra* note 144, at 921.

Where an employer unilaterally introduces a pension program, the retiree has no problem with standing with respect to the employer, since the contract embodying the plan is directly between himself and the employer. Where redress is sought against the non-employer administrators of a pension plan, it may, however, be difficult to deal directly with such administrators since they ordinarily have no formal contractual obligations with the employer. In such cases, unless a fiduciary duty is found by a court as between the administrator and the pensioner there would be no grounds for action on a third-party beneficiary theory.

*Id.*

<sup>147</sup> See, e.g., *Menke v. Thompson*, 140 F.2d 786 (8th Cir. 1944), in which the plaintiff-retiree claimed that the pension plan at issue constituted a binding contract. *Id.* at 791. The court, however, found that the employee's continuous service for 25 years immediately prior to retirement was a condition precedent to the employer's obligation to pay pension benefits. *Id.* The court then held that since there was a three month break in the employee's 42 years of employment, occurring 10 years prior to his retirement, he had no enforceable right in the pension fund. *Id.* at 791, 792.

<sup>148</sup> 29 U.S.C. § 186 (1970). For a concise analysis of judicial treatment of section 302, see Goetz, *Employee Benefit Trusts Under Section 302 of Labor Management Relations Act*, 59 Nw. U.L. REV. 719 (1965).

<sup>149</sup> S. REP. NO. 105, 80th Cong., 1st Sess. 52 (1947); H.R. REP. NO. 245, 80th Cong., 1st Sess. 29-30 (1947). See also Landau, Merholtz & Perkins, *Protecting a Potential Pensioner's Pension—An Overview of Present and Proposed Law on Trustees' Fiduciary Obligations and Vesting*, 40 BROOKLYN L. REV. 521, 530-31 (1974).

<sup>150</sup> 29 U.S.C. § 186(c)(5) (1970).

Section 302(a) makes it unlawful for an employer to make payments to employees or union representatives except under specified conditions.<sup>151</sup> Section 302(c)(5) exempts from this general prohibition payments to trust funds established for the sole and exclusive benefit of employees, provided, *inter alia*, that these funds are held in trust for the purposes of pension benefits and that the trust agreement is jointly administered by an equal number of employer and employee representatives.<sup>152</sup> Although legislative concern at the time of the enactment of section 302 centered on union diversion of pension funds,<sup>153</sup> the statutory solution was similar to the solution offered in ERISA, namely, the enactment of a federal trust law standard. By including in section 302(c)(5) the requirement that a qualifying trust be for the sole and exclusive benefit of the prescribed class of beneficiaries, Congress effectively federalized the common law proscription against breach of trust.

A combination of punctiliousness regarding jurisdictional matters and awkwardness regarding fiduciary questions has discouraged the federal courts from enforcing the standards set forth in section 302. More often than not, federal district courts have refrained from exercising their equity jurisdiction under section 302(e)<sup>154</sup> when asked to enjoin questionable uses of trust assets or irresponsible administrative behavior.<sup>155</sup> This reluctance on the part of the federal courts has stemmed largely from their concern over improper federal usurpation of the supervision of trust administration.<sup>156</sup> a function traditionally reserved to state courts of equity.<sup>157</sup> Hence, it has been held that jurisdiction under Section 302(e) is limited to restraining violations of the basic structural requirements of section 302 and that it does not extend to fiduciary obligations or standards of prudence in the administration of funds.<sup>158</sup>

<sup>151</sup> *Id.* § 186(a).

<sup>152</sup> *Id.* § 186(c)(5).

<sup>153</sup> S. REP. NO. 105, 80th Cong., 1st Sess. 52 (1947); SUBCOMM. ON WELFARE AND PENSION FUNDS OF THE SENATE COMM. ON LABOR AND PUBLIC WELFARE, WELFARE AND PENSION PLANS INVESTIGATION, S. REP. NO. 1734, 84th Cong., 2d Sess. 17 (1956). *See also* Lewis v. Benedict Coal Corp., 361 U.S. 459 (1960).

<sup>154</sup> 29 U.S.C. § 186(e) (1970).

<sup>155</sup> Some district courts have seen in this section a foundation on which to rest rather broad powers of policing welfare trust administration. Indeed we may have contributed to this scattering of cases . . .

We are, however, persuaded that the weight of reason and authority compels a narrow reading of section 302(e).

*Bowers v. Ulpiano Casal, Inc.*, 393 F.2d 421, 423-24 (1st Cir. 1968) (citations omitted). *See, e.g.*, *Insley v. Joyce*, 330 F. Supp. 1228, 1231 (N.D. Ill. 1971). *See also* Landau, Merholtz & Perkins, *supra* note 149, at 539.

<sup>156</sup> *See* *Employing Plasterers' Ass'n of Chicago v. Journeymen Plasterers' Soc'y Local 5*, 279 F.2d 92, 97 (9th Cir. 1960).

<sup>157</sup> *See* text at note 126 *supra*.

<sup>158</sup> *E.g.*, *Bowers v. Ulpiano Casal, Inc.*, 393 F.2d 421, 424 (1st Cir. 1968); *Employing Plasterers' Ass'n of Chicago v. Journeymen Plasterers' Local 5*, 279 F.2d 92, 97 (9th Cir. 1960). For a case in which section 302(e) jurisdiction was successfully invoked

The hesitancy of some federal courts to oversee the operation of employee benefit funds is also arguably derived in part from an inability to distinguish between those aspects of pension plan administration bearing on the "sole and exclusive benefit" of employees protected by the statute, and those aspects of the operation of trusts which may be questioned on grounds of non-compliance with the trust agreement or lack of authority in the trustee. Indeed, one author has concluded that "[t]he statutory language and the congressional intent suggest the possibility of more extensive review by the Federal courts of fund activities which are questioned on the basis that they are not for the 'sole and exclusive benefit of employees.'"<sup>159</sup> In any event, section 302 has not generated a substantial body of case law defining a federal fiduciary standard in the context of pension trust investment. In fact, section 302(c)(5) has generally been applied to pension investments only in rare cases of manifest self-dealing where the court did not have to approach the troublesome issue of prudence.<sup>160</sup>

#### D. Welfare and Pension Plans Disclosure Act

Even if trust law as applied to private pension plans had created strict, readily enforceable fiduciary standards, gaps in the disclosure requirements of the Welfare and Pension Plans Disclosure Act (WPPDA)<sup>161</sup> would have made detection of improper investments by participating employees extremely difficult. It is thus not surprising that the WPPDA was repealed by ERISA.<sup>162</sup> Not the least of the WPPDA's limitations was the narrow scope of its coverage—only plans with more than twenty-five employees were protected.<sup>163</sup> The inadequacy of this coverage becomes evident in light of data abstracted from the termination record files of the Internal Revenue Service, which indicates that at least two-thirds of all plans which terminated between 1955 and 1965 covered fewer than twenty-five employees.<sup>164</sup>

The WPPDA was also inadequate in its reporting requirements. Essentially, the WPPDA required two kinds of reports: (1) a descrip-

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to review the propriety of trust investments, see *In re Bricklayers' Welfare Fund*, 159 F. Supp. 37 (E.D. Pa. 1958).

<sup>159</sup> Goetz, *supra* note 148, at 750.

<sup>160</sup> See, e.g., *Blankenship v. Boyle*, 329 F. Supp. 1089 (D.D.C. 1971), in which it was held that the intimate relationship between the union's financial activities and the organizing activities of the trustees compelled the conclusion that the trustees of the mine workers' welfare fund were acting primarily for the collateral benefit of the union in making most of their utility stock acquisitions. *Id.* at 1106. The court held that such behavior demonstrated overt self-dealing on the part of the trustees and constituted a breach of trust. *Id.*

<sup>161</sup> 29 U.S.C. §§ 301-09 (1970).

<sup>162</sup> 29 U.S.C.A. § 1031 (1975).

<sup>163</sup> 29 U.S.C. § 303(b)(4) (1970).

<sup>164</sup> Beier, *Terminations of Pension Plans: Eleven Years' Experience*, 90 MONTHLY LABOR REV. 26, 26 (June, 1967).



tion of the plan, to be filed with the Secretary of Labor by all sponsoring employers;<sup>165</sup> and (2) an annual financial report to be filed within 150 days after the end of the fiscal year by all plans which covered more than 100 employees.<sup>166</sup> Although the WPPDA required plan descriptions and financial reports to be "published" for the benefit of employees, section 307 narrowly defined "publication" as requiring only that copies be made available in the principal office of the plan upon the request of a participating employee.<sup>167</sup> These disclosure provisions focused largely on the financial status of the plan and failed to provide employees with information relevant to their protection in the investment transactions of the fund. Only a summary by broad portfolio categories was required in the financial statements.<sup>168</sup> In addition, financial information could be reported at the value used in reporting to the Treasury or, if such reports were not filed, at the lower of current value or aggregate cost.<sup>169</sup> Thus, there was no guarantee that annual reports would provide participants with information on the current market value of the plan assets. Moreover, the absence of current reports on cash flow, purchases and sales, and the market valuation of the portfolio made it virtually impossible to determine a rate of return on investments adjusted to accommodate the risk of loss.<sup>170</sup>

The flexibility of generally acceptable accounting principles did not contribute to the effectiveness of the WPPDA.<sup>171</sup> Although companies would be required to disclose the size of unfunded pension liabilities for *vested* benefits under those principles, no such general requirement would extend to the expected liabilities for *unvested* benefits. As a result, a financial statement setting forth the extent to which the fund's expected liabilities exceed the fund's assets could be deceptive, especially where vesting provisions were rather strict.

The failure of the WPPDA was also in part attributable to the problem of the effectiveness of communication regarding a plan's contents. As stated by the Senate Committee on Labor and Public Welfare: "[A]n average plan participant, even where he has been furnished an explanation of his plan provisions, often cannot comprehend them because of the technicalities and complexities of the language used."<sup>172</sup> In addition, the assumptions which employees bring to participation in pension plans contributed to the WPPDA's

<sup>165</sup> 29 U.S.C. § 305 (1970).

<sup>166</sup> *Id.* § 306(a).

<sup>167</sup> *Id.* § 307(a)(1).

<sup>168</sup> *Id.* § 306(b).

<sup>169</sup> *Id.* § 306(f)(1)(B).

<sup>170</sup> INSTITUTIONAL INVESTOR, vol. V, No. 9,993 (August 1971) [hereinafter INSTITUTIONAL INVESTOR].

<sup>171</sup> The Act provides that the information required in § 306(b) may be "certified to by an independent certified or licensed public accountant, based upon a comprehensive audit conducted in accordance with accepted standards of auditing . . ." 29 U.S.C. § 306(b) (1970).

<sup>172</sup> S. REP. NO. 127, 93d Cong., 1st Sess. 11 (1973).

failure. No amount of disclosure of the operations of a pension trust is likely to persuade an employee that he is a trust beneficiary. Employees relate to the promise of pension benefits as they do to any other conditions of employment; the imposition of an unintelligible legal superstructure upon their expectations is thus not apt to alert them to risks which they do not perceive.

The fundamental weakness of the WPPDA, however, was not in its specific omissions, but rather in the broad legislative judgment that disclosure coupled with employee enforcement could effectively achieve regulatory goals in the area of private pension plans. Wholly lacking in substantive fiduciary standards, the WPPDA relied on the initiative of individual employees to discern wrongdoing and to enjoin it.<sup>173</sup> Experience, however, has borne out the criticism that such reliance is unrealistic. Union members are not only reluctant to challenge their union leaders, but they are also ill-equipped to police their employers.

### III. CONFLICTS OF INTEREST

The conflicts of interest problem inherent in employer management of pension funds arises because of two factors: (1) the risk of loss from unwise investment generally falls upon the employees; and (2) the benefit from favorable performance on pension fund investment redounds almost exclusively to the employer. Because of these two factors, the employer stands with much to gain, but little to lose in investing pension funds.

That the risk of loss from unwise investment generally falls on the employee is clear. Funding patterns prior to ERISA suggested that unless coverage was continued through the transfer of credits to another pension plan, workers stood to lose between 60 percent and 80 percent of total accrued benefits if their plan terminated in its fifth year.<sup>174</sup> A Department of Labor study indicates that between 1955 and 1965, pension plans which terminated did, in fact, tend to be relatively new—more than half had been in existence for less than six years.<sup>175</sup>

The minimum funding requirements of the Code further contribute to this situation. Under the Code, normal costs must be funded as they accrue.<sup>176</sup> However, a substantial unfunded liability is usually created when a new plan is established if participants are given either full or partial credit for earlier service.<sup>177</sup> Under the Code, the employer is not required to fund these past service costs; he

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<sup>173</sup> Landau, Merholtz & Perkins, *supra* note 149, at 547, citing BNA, FEDERAL-STATE REGULATION OF WELFARE FUNDS 58 (rev. 1962); H.R. REP. NO. 998, 87th Cong., 1st Sess. (1962).

<sup>174</sup> Beier, *supra* note 164, at 26-27.

<sup>175</sup> *Id.* at 30.

<sup>176</sup> See Treas. Reg. § 1.401-6(c)(ii).

<sup>177</sup> Beier, *supra* note 164, at 28.

can simply pay interest on them.<sup>178</sup> Moreover, the Code sanctions the allocation of experience losses to the unfunded past service costs.<sup>179</sup> As a result, it is probable that the assets of a terminating plan will prove inadequate to satisfy all of the plan's obligations.

Limited liability on the part of the employer also serves to place the risk of loss from unwise investment on the employee. Most large plans contain language which has the effect of limiting the employer's liability to employees to property in the trust fund<sup>180</sup> and provisions permitting the employer to modify the plan at his discretion.<sup>181</sup> The trust indenture itself inevitably includes clauses exculpating the trustee from liability for loss or diminution of the fund unless such loss is caused by the trustee's wilful misconduct.<sup>182</sup> The effect of a well-drawn plan thus is to protect the employer against financial commitments of an unknown magnitude and an indeterminate duration. This limitation on the employer's liability catalyzes an aggressive management policy, whereas a cost push merely encourages it. Such a plan also has the effect of depriving the employees of any real confidence in the employer's promise of retirement benefits. The Code offers some protection to employees covered by terminating unilateral plans by requiring that all accrued benefits vest upon termination.<sup>183</sup> However, this mandatory vesting was originally of little comfort where the plan terminated with insufficient funds to provide the expected benefits. Treasury Regulations mitigate this menace by providing that a qualifying plan implies a "permanent program."<sup>184</sup> Therefore, while the employer can reserve the right to change or terminate the plan, its abandonment for any reason other than business necessity within too short a time after its creation might result in retroactive disqualification.<sup>185</sup> By threatening an employer with tax disadvantages the Code diminishes the likelihood of termination. Nevertheless, the problems of under-funding are still present and the risk of loss is still upon the employees.<sup>186</sup>

Of equal importance in the conflicts of interest problem is the fact that the benefit from favorable pension fund performance redounds almost exclusively to the employer. The employer's contribu-

<sup>178</sup> See Treas. Reg. § 1.401-6(c)(ii).

<sup>179</sup> See *id.* § 1.401-7(a).

<sup>180</sup> Beier, *supra* note 164, at 29. Thus, any deficit in the plan's finances would not be chargeable against the company's assets in the event of the pension plan's default—the burden of any asset deficiency would be on the plan's participants. See *id.*

<sup>181</sup> CCH PENSION AND PROFIT SHARING PLANS AND CLAUSES ¶ 34,008, at 209 (1957).

<sup>182</sup> See note 144 *supra*.

<sup>183</sup> INT. REV. CODE OF 1954, § 401(a)(7).

<sup>184</sup> Treas. Reg. § 1.401-1(b)(2).

<sup>185</sup> *Id.*

<sup>186</sup> For brief discussions of the legal environment in which plans are established and claims are enforced, see B. AARON, LEGAL STATUS OF EMPLOYEE BENEFIT RIGHTS UNDER PRIVATE PENSION PLANS 107 (1961); Levin, *Proposals to Eliminate Inequitable Loss of Pension Benefits* 15 VILL. L. REV. 527 (1970).

tion formula is determined on the basis of an actuarial assumption of fair return on accumulated assets; a higher return than predicted thus results in temporary "over-funding." Depending on the circumstances, the Service permits such "experience gains" (actual return in excess of predicted return) to reduce the costs of the plan either currently or through one of several spreading methods.<sup>187</sup> However, amounts needed to compensate for experience losses can be added directly to past service costs,<sup>188</sup> and thereby remain permanently unfunded. Such asymmetrical treatment of experience gains and losses offers no incentive at all for conservatism on the part of the employer-trustee. Indeed, with his costs reduced on the upside and not meaningfully increased on the downside, his pursuit of more speculative investments is perfectly rational.

In addition, higher than expected returns create a "surplus" in the fund equal to the excess of accumulated assets over liabilities. On termination of the fund, and after satisfaction of all liabilities to employees, the employer can recover whatever surplus remains, as long as it arose out of an "erroneous actuarial computation."<sup>189</sup> This exception to the non-diversion rule of section 401(a)(2) of the Code offers a cost-conscious, performance-oriented investment manager yet another inducement to seek attractive, high risk-high gain securities. Finally, the prospect of a steady increase in the cost of retirement programs also encourages an emphasis on maximum return.

For these reasons, it is not surprising that pension funds are increasingly being invested in the stock market. Preoccupation with performance has signaled a move in the direction of high risk-high gain investments and has drawn attention to the inherent conflicts of interest which exist where an employer retains investment control.<sup>190</sup> Notions of fiduciary restraint under prior law have been rendered

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<sup>187</sup> See Rev. Rul. 59-153, 1959-1 Cum. Bull. 89, which discusses pension plans using the "entry age normal method" where adjustment for gains is generally made by deducting the amount of gain arising in any year from the next year's deductible limit under section 404(a)(1)(C) of the Code. *Id.* at 90. See also Rev. Rul. 65-310, 1965-2 Cum. Bull. 145, which in some situations permits spreading the adjustments for gain as an automatic part of current and future normal costs.

<sup>188</sup> Rev. Rul. 57-550, 1957-2 Cum. Bull. 266, 267.

<sup>189</sup> Treas. Reg. § 1.401-2. This surplus due to an "erroneous actuarial computation" must arise

because actual requirements differ from the expected requirements even though the latter were based upon previous actuarial valuations of liabilities or determinations of costs of providing pension benefits under the plan and were made by a person competent to make such determinations in accordance with reasonable assumptions as to mortality, interest, etc., and correct procedures relating to the method of funding.

*Id.*

<sup>190</sup> In a sample of 135 large companies responding to an SEC questionnaire, 110 responded "yes" to the question: "Does the employer attempt to measure the 'performance' of any of the plan's manager(s)?" The SEC concluded that this response lent support to assertions that private plans are becoming increasingly conscious of investment return on their accounts. INSTITUTIONAL INVESTOR, *supra* note 170, at 1008.

largely a matter of rhetoric. One experienced pension fund manager has stated:

[T]he investment manager should determine what type of boundaries of risk he intends to operate in. The extent of his own research capabilities is an important factor in making this determination and he should not be led into operating in areas with which he is unfamiliar and where the degree of risk involved calls for more knowledge and attention than his organization can successfully produce.<sup>191</sup>

However, because risk has remained ill-defined and difficult to measure, any limitations on investment policy have survived solely by dint of the administrator's good faith. Insofar as the recent increase in common stock holdings and annual turnover rates by pension funds signifies a greater willingness to participate in risky investments, one must conclude that traditional standards of fiduciary conservatism have been subsumed by recent conceptions of the more profitable portfolio.<sup>192</sup>

#### IV. THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

The Employee Retirement Income Security Act of 1974<sup>193</sup> is the culmination of a decade of legislative investigations, and three years of intensive congressional hearings, concerning the administration and operation of the pension plan system.<sup>194</sup> Underlying ERISA is the intent of Congress to assure that "the equitable character" and "the financial soundness" of pension plans be protected "in the interests of employees and their beneficiaries . . .".<sup>195</sup> The purpose of the legislation is thus to ensure that employees will receive anticipated benefits either when they retire or upon termination of the plan.<sup>196</sup> To achieve this end, the Act adopts "minimum standards with regard to participation and vesting."<sup>197</sup>

##### *A: Participation and Vesting*

Pension plans have traditionally had age and service conditions that employees were required to meet before they were deemed eligible to participate in the plan. In the past, only the Code regulated these conditions by providing that the plan could not discriminate in

<sup>191</sup> Blanchard, *Pension Investment Performance vs. Fiduciary Responsibility*, 110 TRUSTS AND ESTATES 666, 667 (1971).

<sup>192</sup> Common stock held by corporate plans increased at a rate of 53.6% from 1964 to 1969; the annual turnover rate went from 7.5% in 1965 to 17.2% in 1969. INSTITUTIONAL INVESTOR, *supra* note 170, at 1287.

<sup>193</sup> 29 U.S.C.A. §§ 1001-1381 (1975).

<sup>194</sup> See 119 CONG. REC. 30003 (1973).

<sup>195</sup> 29 U.S.C.A. § 1001 (1975).

<sup>196</sup> See *id.*

<sup>197</sup> *Id.*

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favor of highly-compensated employees, officers, stockholders, or supervisory personnel.<sup>198</sup> The plan was also required to benefit a minimum percentage of all employees.<sup>199</sup> Finally, a plan could qualify under the Code for tax-exempt status by providing that the rights of employees in the pension fund vested upon the age of retirement or upon plan termination.<sup>200</sup>

ERISA establishes minimum participation and vesting requirements for pension plans. Under the Act, any employee who is 25 years of age or over and has completed at least one year of service must be eligible to participate in the plan,<sup>201</sup> although under a defined benefit plan the employer may exclude employees whose age when hired was within five years of the plan's retirement age.<sup>202</sup> In addition, if the plan provides that each participant has a right to 100 percent of his accrued benefit after not more than three years of service, an employee may be required to complete three years of service before becoming eligible to participate in the plan.<sup>203</sup>

To satisfy the minimum vesting standards of the Act, a pension plan must meet one of three schedules.<sup>204</sup> First, the plan may provide for full vesting of all benefits after ten years of credited service.<sup>205</sup> Second, the plan may provide for 25 percent vesting after five years of service, with annual accretions of five percent over the next five years and annual accretions of ten percent over the following five years.<sup>206</sup> Finally, the plan may provide for vesting under a "rule of 45," which requires 50 percent vesting of benefit credits for an employee who has at least five years of service and whose age plus years of service equal 45.<sup>207</sup> An additional vesting of ten percent annually over the next five years completes this schedule.<sup>208</sup> However, to satisfy this final alternative, an employee must be 50 percent vested after ten years of service and receive a ten percent increment in vested rights each year thereafter.<sup>209</sup> These minimum participation and vesting standards mandated by the Act deprive the sponsor of the plan of a great deal of his former discretion in shaping its contours.<sup>210</sup>

### *B. Reporting and Disclosure*

ERISA repealed the Welfare and Pension Plans Disclosure Act<sup>211</sup>

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<sup>198</sup> INT. REV. CODE OF 1954 § 401(a)(4).

<sup>199</sup> *Id.* § 401(a)(3).

<sup>200</sup> *Id.* § 401(a)(7).

<sup>201</sup> 29 U.S.C.A. § 1052(a)(1)(A) (1975).

<sup>202</sup> *Id.* § 1052(a)(2)(B).

<sup>203</sup> *Id.* § 1052(a)(1)(B)(i).

<sup>204</sup> *Id.* § 1053(a)(2).

<sup>205</sup> *Id.* § 1053(a)(2)(A).

<sup>206</sup> *Id.* § 1053(a)(2)(B).

<sup>207</sup> *Id.* § 1053(a)(2)(C)(i).

<sup>208</sup> *Id.*

<sup>209</sup> *Id.* § 1053(a)(2)(C)(ii).

<sup>210</sup> Note, 88 HARV. L. REV. 960, 963 (1975).

<sup>211</sup> 29 U.S.C.A. § 1031 (1975).

and established detailed reporting and disclosure requirements. The Act provides that each pension plan administrator must provide to each participant and beneficiary a summary description of the plan.<sup>212</sup> The summary must include, *inter alia*, the requirements of the plan for eligibility, a description of provisions relating to vested benefits, the source of plan financing, and the procedures to be followed in presenting claims for benefits under the plan.<sup>213</sup> Moreover, the summary plan description must be "written in a manner calculated to be understood by the average plan participant, and must be sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of their rights and obligations under the plan."<sup>214</sup>

The plan administrator is also required to provide each participant and beneficiary with a copy of the statements and schedules from the annual report,<sup>215</sup> which must be prepared by an independent, qualified public accountant.<sup>216</sup> The schedules are required to contain a statement of the assets and liabilities of the plan, aggregated by categories and appraised at their current value.<sup>217</sup> The same data for the end of the previous fiscal year must also be displayed in comparative form.<sup>218</sup>

By setting forth detailed reporting and disclosure requirements, ERISA fills many of the gaps and omissions that were present in the WPPDA. Nevertheless, the fundamental weakness of the WPPDA was resurrected in ERISA, which retains the WPPDA's reliance on the initiative of individual participants to discern and enjoin wrongdoing.<sup>219</sup>

### C. The Federal Fiduciary Standard

ERISA establishes a federal fiduciary standard for trustees of pension plans in their dealings with trust property. Under the Act, a fiduciary is required to administer a pension fund "solely in the interest of the participants and beneficiaries" and for the "exclusive purpose of providing benefits to participants and their beneficiaries . . . ."<sup>220</sup> The fiduciary is required to invest the trust property

with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims . . . .<sup>221</sup>

<sup>212</sup> *Id.* § 1024(b)(1).

<sup>213</sup> *Id.* § 1022(b).

<sup>214</sup> *Id.* § 1022(a)(1).

<sup>215</sup> *Id.* § 1024(b)(3).

<sup>216</sup> *Id.* § 1023(a)(3)(A).

<sup>217</sup> *Id.* § 1023(b)(3)(A).

<sup>218</sup> *Id.*

<sup>219</sup> See note 173 *supra*.

<sup>220</sup> 29 U.S.C.A. § 1104(a)(1)(A) (1975).

<sup>221</sup> *Id.* § 1104(a)(1)(B).

The Act further obliges fiduciaries to diversify the investments of the plan, unless it is clearly prudent not to do so,<sup>222</sup> and to act in accordance with the documents that govern the plan, unless it is inconsistent with the Act to do so.<sup>223</sup> The Act also specifically prohibits fiduciaries from engaging in transactions with parties-in-interest.<sup>224</sup>

The Act broadly defines "fiduciary" to include every person who "exercises any discretionary authority or discretionary control" with respect to an employee benefit fund or who renders, or has the authority or responsibility to render "investment advice for a fee or other compensation" with respect to the assets of the fund.<sup>225</sup> Therefore, under the Act, a fiduciary could be a plan administrator, an investment counselor, a board of individual trustees, or an institutional trustee. In some instances, the effect of such a broad definition will be to impose fiduciary duties on numerous persons who would not be considered trustees under state law.

These significant provisions of ERISA—the federalization of the prudent man rule, the prohibition against certain transactions, and the extension of the prudent man rule to persons who have not heretofore been considered fiduciaries—might appear, at first glance, to accomplish a significant remedial function.

It is at least arguable, however, that by enacting a federal law of private pension plans without setting forth a more explicit and enforceable federal standard for the investment of pension funds, Congress has failed in its purpose of ensuring anticipated pension benefits. In light of the urgency with which Congress has approached the statutory reform of private pension plans and the inescapable conflicts of interest embodied in an employer-managed pension trust, it seems strange that the Act is silent on the issue of investment limitations.

The Act conspicuously avoids the imposition of specific investment restrictions on pension fund managers. It has eschewed articulation of a list of permissible investments. The prudent man standard, as it has been developed in the state law of trusts, is thus implicitly regarded by Congress as sufficient to guard against improper, excessively risky investments on the part of corporate fiduciaries. It is questionable, however, whether mere federal enactment and broadened application will instill in the prudent man standard any greater capacity to define investments appropriate for a trust than has been demonstrated at the state level.<sup>226</sup> This is especially true in light of the failure of the federal courts to fashion a standard which provides effective restraints on investment management under the prudent man rule of section 302 of the Labor-Management Relations Act.<sup>227</sup>

An implied assumption of ERISA appears to be that the failure

<sup>222</sup> *Id.* § 1104(a)(1)(C).

<sup>223</sup> *Id.* § 1104(a)(1)(D).

<sup>224</sup> *Id.* § 1106.

<sup>225</sup> *Id.* § 1002(21)(A).

<sup>226</sup> See text at notes 129-148 *supra*.

<sup>227</sup> See text at notes 155-160 *supra*.



of trust law to safeguard the interest of employees under pension plans was a failure of administration rather than substance. This assumption, however, is subject to question. The prudent man rule as enunciated in ERISA remains as general as state trust law. Neither the Act nor its legislative history explains how this general fiduciary standard is to be interpreted.<sup>228</sup> The joint explanatory statement of the Committee of Conference indicates only that the conferees expect that the courts will interpret the prudent man rule with a proper regard for "the special nature and purpose of employees benefit plans."<sup>229</sup> This statement, however, provides little guidance in fashioning a workable standard. What is the "special nature" of employee benefit plans? The language employed by the Committee is as general as the standard itself.

Indeed, it can be argued that the "special nature" of employee benefit plans works against, rather than in favor of, the application of the prudent man standard to investment of pension plan funds. The prudent man rule evolved in response to the traditional tension between income beneficiaries and remaindermen.<sup>230</sup> Conventionally, the trustee was required to make a fair and reasonable allocation of trust property between investments favorable to one or the other of the two parties.<sup>231</sup> Therefore, trust law emphasized a prudent balance between the preservation of principal and current yield. Because the remaindermen and the income beneficiaries in a pension trust are the same person, however, this problem is not faced by the pension fund investor.<sup>232</sup> Only if the interests of the employer-sponsor and the employee-participants are genuinely in conflict so as to preserve that traditional tension can the prudent man rule possess continuing vitality in the pension context. However, an employer managing a pension trust benefits from favorable performance both in the short run and in the long run. Like an income beneficiary under a personal trust, an employer is naturally inclined toward higher current gains at possible risk to principal in order to minimize current pension costs. As a settlor recovering surplus on termination of the plan, however, the employer resembles the remainderman whose personal interest in the remainder might influence him toward adopting a more conservative investment policy. Therefore, the traditional balance of trust law between the preservation of principal and current yield *may* inhere to a degree in the pension trust, insofar as the employer may play out the drama himself. On the other hand, to the extent that an employer, who has no legal obligation to compensate the fund for investment losses,<sup>233</sup> sacrifices security and his more remote remainder interest in

<sup>228</sup> Note, 88 HARV. L. REV. 960, 964 (1975).

<sup>229</sup> S. CONF. REP. NO. 1090, 93d Cong., 2d Sess. 302 (1974).

<sup>230</sup> 2 A. SCOTT, THE LAW OF TRUSTS § 183, at 1471-72 (3d ed. 1967); 3 *id.* § 232, at 1894-96.

<sup>231</sup> 3 *id.* § 232, at 1894-96.

<sup>232</sup> P. DIETZ, PENSION FUNDS: MEASURING INVESTMENT PERFORMANCE 5 (1966).

<sup>233</sup> See text at note 180 *supra*.

order to maximize current income, thereby minimizing current costs, the traditional balance is lost.

A trustee is ordinarily under a duty to invest the trust funds so that they will be productive of income.<sup>234</sup> One author notes the absence of specific language requiring the current production of income in recent state enactments which attempt to define the pension trustee's fiduciary responsibility.<sup>235</sup> He suggests that this may indicate legislative recognition that employee benefit trusts are different from ordinary trusts and that there is no particular virtue in income as compared to capital gain, nor in realized as compared with unrealized gain.<sup>236</sup> Based on similar statutory silence in ERISA he also suggests the possibility that enactment of a federal prudent man rule intends a similar modification of the IRS investment guidelines.<sup>237</sup>

Another problem arises from the fact that trust fiduciary principles were developed in situations in which the trustee was presumably independent of the settlor and the beneficiaries.<sup>238</sup> In unilaterally established pension plans this is rarely the case. Where the sponsoring employer dominates the investment powers of the trustee, the trustee is, by definition, an interested party. Consequently, it is anomalous to tailor an employer-managed fund to a fiduciary standard requiring investment for the "sole benefit of the employees." The fact that the Service has never read the exclusive benefit requirement literally perhaps signifies an intended revision of ordinary trust law to adapt it to the peculiarities of pension trusts.<sup>239</sup>

In practice, the relationship between the employer, the trustee, and the employee appears to preclude the application of flexible fiduciary principles dependent on the enforcement efforts of vigilant beneficiaries. The competing interests of life beneficiaries and remaindermen under personal trusts motivate these individuals to exercise careful, protective supervision over the investments by the trustee. The prudent man rule recognizes this fundamental tension and places definition of the legal standard in the hands of the parties whose interests it purports to protect. It is therefore implicit in the vagueness of the rule that its effectiveness resides in recognition of these competing interests and establishment of a forum for their resolution. This approach, however, seems inappropriate where the trust beneficiaries are employees and the provocative tension between income beneficiaries and remaindermen is absent. The employee's role in the

<sup>234</sup> 2 A. SCOTT, *supra* note 230, § 181, at 1463 and cases cited therein.

<sup>235</sup> Welch, *Investment for and Management of Employee Benefit Trusts*, 110 TRUSTS AND ESTATES 350, 352 (1971).

<sup>236</sup> *Id.* at 352, 353.

<sup>237</sup> *Id.* at 353.

<sup>238</sup> J. RITCHIE, N. ALFORD, JR., & R. EFFLAND, *DECEDENTS' ESTATES AND TRUSTS* 397 (4th ed. 1971).

<sup>239</sup> The law governing charitable corporations in their investment of endowment funds presents a comparable development. Like pension funds, endowment funds are *sui generis*, necessitating judicial flexibility in the application of ordinary trust principles. Cary & Bright, *The "Income" of Endowment Funds*, 69 COLUM. L. REV. 396 (1969).

system of pension trusts is primarily passive. He seldom has any way of knowing whether or not his interests are being adequately advanced; he has little comprehension of the information that would enable him to activate a fiduciary standard in restraint of the fund manager. This recognition may conduce to the conclusion that unilateral plans must be administered by an independent trustee if "fiduciary responsibility" and "exclusive benefit" are to have any substance whatsoever.

#### D. Funding

The failure of ERISA to significantly improve upon the prudent man rule and to provide an operative norm for investment decision-making is mitigated, in part, by the mechanical capacity of ERISA to surcharge a fiduciary for excessive risk.<sup>240</sup> ERISA may accomplish—in the structural relationship between a minimum funding standard, an excise tax on funding deficiencies, and a reinsurance program—that which it may prove incapable of accomplishing through the enactment of a federal prudent man standard.

Under the minimum funding standards of the Act, the normal cost of the plan for the plan year must be funded on a current basis.<sup>241</sup> In the case of a plan in existence on January 1, 1974, the unfunded past service liability must be amortized over a period of 40 years in equal annual installments.<sup>242</sup> In the case of a plan which comes into existence after January 1, 1974, the unfunded past service liability must be amortized over a period of 30 years.<sup>243</sup> In addition, any net experience loss must be amortized separately over a period of 15 years in equal annual installments.<sup>244</sup>

In addition to establishing minimum funding standards, the Act imposes a tax on the failure to meet those standards. For each taxable year, a tax of five percent is levied on the accumulated funding deficiency existing under the plan.<sup>245</sup> If the accumulated funding deficiency is not corrected within 90 days, a tax of 100 percent is imposed upon the uncorrected deficiency.<sup>246</sup>

Nevertheless, the minimum funding requirements appear to be inadequate. Many pension plans terminate long before the expiration of 15 years.<sup>247</sup> It is therefore doubtful that the amortization of net experience losses over a period of 15 years will contribute in any significant way towards creating an adequacy of funding. The problem becomes more critical in the case of unfunded past service costs which

<sup>240</sup> 29 U.S.C.A. § 1109(a) (1975).

<sup>241</sup> *Id.* § 1082(b)(2)(A).

<sup>242</sup> *Id.* § 1082(b)(2)(B)(i).

<sup>243</sup> *Id.* § 1082(b)(2)(B)(ii).

<sup>244</sup> *Id.* § 1082(b)(2)(B)(iv).

<sup>245</sup> 26 U.S.C.A. § 4971(a) (1975).

<sup>246</sup> *Id.* § 4971(b), (c)(3).

<sup>247</sup> See text at notes 253 & 274 *infra*.

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can be amortized over a period of as long as 40 years. Here the likelihood of plan termination prior to full amortization is even greater.

ERISA also establishes the Pension Benefit Guaranty Corporation to insure that participants in private plans are protected against termination of the plan under which they are covered.<sup>248</sup> In the event that a defined benefit plan terminates, the insurance, which is financed through employer premiums, covers vested pension benefits up to \$750 monthly.<sup>249</sup> However, if the plan terminates within five years after its creation, vested benefits are only partially insured.<sup>250</sup> The employer may be held liable for up to thirty percent of his net worth for these insurance payments, which must be made upon the termination of a plan.<sup>251</sup>

The termination insurance provided for in ERISA is inadequate in two respects. First, it does not provide insurance for defined contribution pension plans, leaving this class of plans with no coverage at all. Second, it provides only partial coverage for participants in defined benefit plans which came into existence less than five years prior to termination.<sup>252</sup> In view of the fact that more than half of the pension plans which were terminated between 1955 and 1965 had been in existence for less than six years,<sup>253</sup> this limitation significantly circumscribes the Act's potential for guaranteeing benefits.

The minimum funding standard and the reinsurance program also fail on a more elementary level. The funding and reinsurance provisions serve only to mitigate the *consequences* of pension fund failure. A basic *cause* of fund failure—the lack of an effective standard for investment decision-making—is unaffected by the funding and reinsurance provisions. Thus, they offer only symptomatic relief to the continuing dangers of breach of trust.

## V. INVESTMENT RESTRICTIONS UNDER ERISA

In 1965, the President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs rejected the direct regulation of investment. "In view of the wide legitimate differences regarding the most advantageous balance of retirement funds investments," the Committee concluded that it was undesirable to "require conformity to a prescribed rule with respect to the proportion of stocks to other investments."<sup>254</sup> In enacting ERISA, Congress ap-

<sup>248</sup> 29 U.S.C.A. § 1302(a).

<sup>249</sup> *Id.* § 1322(b)(3).

<sup>250</sup> *Id.* § 1322(b)(8).

<sup>251</sup> *Id.* § 1362(b).

<sup>252</sup> *Id.* § 1322(b)(8).

<sup>253</sup> Beier, *Terminations of Pension Plans: Eleven Years' Experience*, 90 MONTHLY LABOR REV. 26, 26-27 (June 1967). This data was abstracted from the termination record files of the Internal Revenue Service. *Id.*

<sup>254</sup> PRESIDENT'S COMMITTEE ON CORPORATE PENSION FUNDS AND OTHER PRIVATE RETIREMENT AND WELFARE PROGRAMS, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS: A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS XV (1965).

parently adopted the Committee's view, for the Act does not impose specific investment restrictions on the investment managers of pension plans.

The enactment of a prudent man rule on the federal level, without explicit investment guidelines, makes little or no sense where portfolio analysis and elusive measures of risk and return are the only governing standards of prudence. Assuming that a trustee can distill risk and return, it is nearly impossible for him to select, from an infinite range of efficient portfolios, that risk level which is "appropriate" under the prudent man rule. The inevitable linchpin in any regulatory solution to the problem of risk is the determination of risk preferences. Moreover, once determined, there is still the question of whether the legal norm should be stricter where a plan is unilaterally established and employer-managed than where it is collectively bargained.

It is at this point that financial analysis is of no assistance in the establishment of a legal standard. Rational investors will choose among risky alternatives by assigning to each a subjective value which takes into account their desire for expected return as well as the risk they expect to encounter in the investment process.<sup>255</sup> Using the economist's concept of the utility curve, the investor must decide where he wants to be on a hypothetical expected return versus risk line.<sup>256</sup> Though it may be relatively easy to construct an approximation of an individual's so-called "utility function," the trustee investing for a group of beneficiaries must impute numerous risk preferences which he can defend on the grounds of prudence.<sup>257</sup> This determination itself contributes to a hopeless confusion which undermines the ability of the legal standard to establish objective criteria. Where a pension trustee with a definite self-interest in the performance of the fund must choose investments only on the strength of "logic and custom,"<sup>258</sup> the utility of such a standard must be questioned. Moreover, even if the standard were capable of definitive application in the context of an individual investment, it would probably still not be enforceable, because under modern portfolio theory risk should only be evaluated on the basis of the portfolio as a whole.

For these reasons, the question of specific investment regulation may now be ripe for reconsideration. Partial regulation, as in the New York "mixed" statute<sup>259</sup> or as in an exclusive legal list of permissible

<sup>255</sup> Cf. P. DIETZ, PENSION FUNDS—MEASURING INVESTMENT PERFORMANCE 33 (1966). For a summary of the various factors and risks involved in the investment process, see F. AMLING, INVESTMENTS—AN INTRODUCTION TO ANALYSIS AND MANAGEMENT 3-33 (2d ed. 1970).

<sup>256</sup> Cf. P. DIETZ, *supra* note 255, at 33.

<sup>257</sup> For a more thorough discussion of utility functions with regard to pension fund investment managers, see *id.* at 33-36.

<sup>258</sup> Kassouf, *Towards a Legal Framework for Efficiency and Equity in the Securities Markets*, 25 HASTINGS L.J. 417, 428 (1974).

<sup>259</sup> N.Y. ESTATES, POWERS & TRUST LAWS § 11-2.2(a)(1) (McKinney Supp. 1975).

investments, may be the only feasible mechanism for preventing management from making speculative or otherwise unsuitable investments to the potential disadvantage of employees. In attempting to stabilize the financial position of insurance companies and to protect them from undue vulnerability to shifts in general economic conditions, insurance laws almost universally set specific limitations on a life insurer's investments in variable value securities, such as common stock.<sup>260</sup> The general regulatory pattern frequently goes so far as to prescribe a variety of qualitative requirements for permissible investments.<sup>261</sup> This intervention in the management of insurance companies is based on the justification of safeguarding against the dissipation of assets. This same justification applies with equal force to support the regulation of pension funds.

The management of pension funds, in fact, reveals a closer kinship to the investment practices of insurance funds than it does to the administration of personal trusts from whence the prudent man rule was derived. Typically, there is a tension in the policy of insurance companies between safe, low-return investments and high-risk, high-yield investments.<sup>262</sup> As in the case of pension funds, safety of the principal is of paramount public concern. Again, as in the case of pension funds, it is only indirectly, through the reduction of the insurer's costs, that earnings on investments in excess of expected yield redound to the benefit of the policyholder or beneficiary.<sup>263</sup> Insurance funds, like pension trusts, grow through the steady accumulation of regular contributions and the reinvestment of earnings. Thus, in both cases, the continuous inflow of cash contributions, calculated to satisfy predicted disbursements, frees the trustee from constant considerations of liquidity. Furthermore, the absence of a necessary distinction between "principal" and "income"<sup>264</sup> and of the opposition between income beneficiaries and remaindermen permits the pension trustee an alarmingly broad choice in the disposition of trust assets. With public policy so strongly in support of protection of the promised benefits in both cases, it is strikingly anomalous that two such similar entities are treated so differently under the law.

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<sup>260</sup> For a concise discussion of typical policy objectives in insurance company regulations, see Kimball and Denenberg, *The Regulation of Investments: A Wisconsin Viewpoint*, in S. KIMBALL & H. DENENBERG (eds.), *INSURANCE, GOVERNMENT AND SOCIAL POLICY: STUDIES IN INSURANCE REGULATION* (1969).

<sup>261</sup> See, e.g., N.Y. INSURANCE LAWS § 81 (McKinney Supp. 1975).

<sup>262</sup> See note 58 *supra*.

<sup>263</sup> Funds constituting the reserves for the insurance policy are invested so as to earn a return on the basis of which company reserves are calculated and premiums are fixed. Bell & Fraine, *Legal Framework, Trends, and Developments in Investment Practices of Life Insurance Companies*, 17 LAW & CONTEMP. PROB. 45, 71 (1952). The expectation of earnings on the invested premiums reduces the initial cost of insurance. *Id.* In participating life insurance companies, higher than expected returns on fund investment will continue to reduce the cost of payments through dividends to policy holders. *Id.*

<sup>264</sup> Note that a qualifying trust is exempt from tax on both capital gains and ordinary income. INT. REV. CODE OF 1954, § 501(a).

The question remains, however, as to whether the experience with the regulation of insurance companies has been such as to warrant emulation in the area of pension funds. While the protective concerns of state legislatures in regard to both insurance companies and pension funds appear to be the same, the origins of insurance company regulation illuminate an important distinction. Insurance company regulation developed in reaction to inter-corporate abuses<sup>265</sup> rather than to fear of unwise investment on the part of asset managers. At the turn of the century, wide latitude had been permitted to insurance fund investments.<sup>266</sup> In 1905, however, the highly influential Report of the Armstrong Committee<sup>267</sup> concluded that common stock was an inappropriate investment for insurance companies because of the potential for self-dealing.<sup>268</sup> When insurance companies controlled corporations engaged in other businesses, the risk of loss to policyholders was simply too great if the company was allowed to invest in the controlled corporations. It has been suggested that although the report categorically stated that common stock was inherently unsuitable,<sup>269</sup> there was no evidence to support its conclusion.<sup>270</sup> Nevertheless, its recommendation prohibiting investment in common equities has "cast a long shadow" over state legislative policies ever since.<sup>271</sup> Indeed, critics of insurance regulation have consistently been in favor of undoing the influence of the Armstrong Investigation and easing the restrictions on insurance company investments.<sup>272</sup>

Challenges to the continuing validity of regulation in the area of insurance, however, may not be appropriate when addressed to pension funds. Insurance companies are long-term investors. The long-term character of the business gives it the strength to ride out depressions and weather diverse fluctuations in the value of its investments which short-term businesses do not have. This strength permits risky investments and militates against restrictive state regulation. Indeed, critics of insurance regulation often rely on this feature and on the fairly convincing evidence of insurer stability to conclude that "the capacity of life [insurance] companies for risk taking is appreciably greater than the degree of risk taking reflected in their investment portfolios."<sup>273</sup>

Pension funds, on the other hand, cannot offer the same

<sup>265</sup> Cf. Bell & Fraine, *supra* note 263, at 46-47.

<sup>266</sup> *Id.* at 46.

<sup>267</sup> This inquiry is also commonly referred to as the Hughes Investigation. *See id.*

<sup>268</sup> Bell & Fraine, *supra* note 263, at 75-76, citing 10 REPORT OF THE LEGISLATIVE INSURANCE INVESTIGATING COMMITTEE 389 (1905).

<sup>269</sup> *Id.*

<sup>270</sup> *Id.* at 75. The author asserts that the only support for the Committee's conclusion lay in the undocumented opinions of two witnesses. *Id.*, citing 2 TESTIMONY TAKEN BY THE LEGISLATIVE INSURANCE INVESTIGATING COMMITTEE 1361 (1905); 5 *id.* at 3889.

<sup>271</sup> Bell & Fraine, *supra* note 263, at 74-75.

<sup>272</sup> *See, e.g., id.* at 76, 78-79.

<sup>273</sup> J. WALTER, THE INVESTMENT PROCESS 61-62 (1962).

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guarantee of endurance. In the 1972 survey of terminating plans by the Department of the Treasury and the Department of Labor, more than 50 percent of all claimants under terminated plans, representing over 40 percent of all benefit losses, were participants in plans less than ten years old.<sup>274</sup> Therefore, the argument in favor of elimination of investment restrictions on insurance companies has only remote bearing on the utility of such restrictions in the pension fund area. The more important question, it would seem, concerns the form such pension plan restraints should take if legislatively imposed.

It is submitted that a code of permissible investments is the necessary alternative to the ineffective prudent man standard. Regardless of the sacrifice of investment flexibility, such specific investment restrictions may, by fiat, eliminate the risk of loss which imprecise portfolio management could not reduce by diversification. If such is the case, the statutory prohibition of any particular quality of risk should result in more than commensurate gain to the security of pension benefits.

Congressional avoidance of investment restrictions on private pension funds in ERISA may reflect an implicit judgment that investment restrictions will increase costs of retirement plans without providing an offsetting benefit. Much has been written on the subject of investment regulation and its relation to efficient portfolio management,<sup>275</sup> but little of this has been conclusive. What does seem clear is that investment controls typically have isolated only one type of risk—funding loss—and in so doing have ignored others.<sup>276</sup> Although the express purpose of regulation has always been to place limits on the degree of risk to which assets will be subjected, critics have charged that such controls are misconceived, are hampering performance, and are forcing managers to take larger risks in order to achieve a given return.<sup>277</sup>

That investment restrictions will increase costs is not an empirically compelled proposition. Attractive as is the logic of portfolio analysis, it may overlook the value of limitations on the risk of loss, even at the expense of overall portfolio efficiency. Certainly, some securities—such as common stock in new companies or in companies with a history of instability—can be categorically excluded from a trustee's choices without gravely affecting the efficiency of the portfolio.

Congress' failure to articulate a code of proper investments may also bespeak the difficulty of the task. Indeed, regulatory patterns have been roundly criticized for their constant emphasis on the poten-

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<sup>274</sup> DEPARTMENT OF THE TREASURY AND DEPARTMENT OF LABOR, STUDY OF PENSION PLAN TERMINATIONS, 1972: FINAL REPORT 39 (1973) (Table 4-3).

<sup>275</sup> *E.g.*, P. DIETZ, PENSION FUNDS—MEASURING INVESTMENT PERFORMANCE (1966).

<sup>276</sup> For a discussion of other types of risk, including liquidity and inflation risk, see Note, 83 HARV. L. REV. 603, 621-23 (1970).

<sup>277</sup> See Note, 82 YALE L.J. 1305 (1973). See also Note, 83 HARV. L. REV. 603 (1970).



tial risk of loss and their equally constant disregard of considerations of return, liquidity, and inflation.<sup>278</sup> The reluctance of Congress to investigate alternative standards for pension trust investment merely demonstrates an uncritical reliance on the prudent man rule, a standard long since proven inadequate at the state level.

### CONCLUSION

The problem of benefit security in an employer-managed pension plan ultimately reduces itself to the question of irreconcilable risk preferences. In a personal trust, tension exists between the needs of income beneficiaries and those of remaindermen. Thus, the independence of the trustee insures an unbiased, though possibly imprudent, resolution of competing investment desires. Where the trustee and income beneficiary are the same, however, as in the employer-managed pension trust, the trustee's judgment must perforce reflect his own self-interest. A legal standard which presumes the trustee's independence therefore cannot effectively safeguard the antagonistic needs of the employee in the pension context. In unilateral, employer-managed pension plans this is a structural inevitability, and it would seem reasonable to expect that any congressional effort to protect the employees' expectations upon retirement would either prohibit the potential conflict of interest or tighten the legal standard applicable to the trustee's investment discretion. ERISA, however, does not prevent an employer from serving as trustee and investment advisor to his own plan, nor does the Act sufficiently elaborate on the prudent man rule to make it functional in this unique form of trust arrangement.

Instead, the Act addresses the problem symptomatically, through expansion of the minimum funding requirements,<sup>279</sup> creation of an excise tax on funding deficiencies,<sup>280</sup> and establishment of a federal reinsurance program.<sup>281</sup> Yet, while annual contributions must accommodate experience gains and losses on investment of the fund, the Act permits such adjustments to contributions to be amortized over as many as fifteen years. Moreover, although the federal insurance corporation will have rights of indemnification against an employer who terminates an under-funded plan, these rights will extend to only one-half of the sponsoring corporation's net worth. It is suggested that the limitations on each of these remedies render them useless in those situations where the need for relief is greatest. In the ordinary case, amortization of investment losses over a period as long as fifteen years cannot effectively preserve the adequacy of funding where so many plans terminate long before the expiration of this period. In the case where an employer whose business is failing takes excessive risks

<sup>278</sup> See, e.g., Note, 83 HARV. L. REV. 603, 616-25 (1970).

<sup>279</sup> 29 U.S.C.A. §§ 1081-85 (1975).

<sup>280</sup> 26 U.S.C.A. §§ 4971(a),(b) (1975).

<sup>281</sup> 29 U.S.C.A. §§ 1301-05 (1975).

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in the management of pension assets, the limitations are of no effect at all.

The Act clearly attempts to accommodate the interests of both labor and management. As the House Ways and Means Committee stated:

In establishing a minimum funding standard for such experience deficiencies, the Committee sought to avoid two problems. If it allowed the experience deficiencies to be funded over a very long period of time, an incentive would be provided for the use of actuarial assumptions that understate the costs since any resulting deficiencies would then be made up over a long period of time without penalty. On the other hand, if the experience deficiencies were required to be amortized over too short a period, employers would encounter hardship in meeting the annual payments.<sup>282</sup>

However, based on the questionable assumption that any effort to increase the security of benefits will increase costs and, to some extent, deter employers from establishing plans or increasing benefits, Congress has reached a solution which probably fails where it is most needed. If the employer is solvent, the suggested funding standard will likely be an efficient corrective mechanism. However, if the employer is insolvent, it will be of virtually no protection to beneficiaries' interests.

The fundamental issue under ERISA continues to be adequate description and communication of risk levels such that a realistic plan may be attained. The limits of present disclosure obligations prevent the flow of information to employees which would clarify the quality of their benefit expectations. In light of these limitations, Congress' decision to employ a prudent man standard to govern pension investment choices appears to be a disappointing conclusion to an honorable quest. Although the contribution of a funding standard and an insurance program probably offers a judicious and realistic response to the need for benefit security, it leaves unanswered the more important question of what constitutes good sense in the context of an employer-managed trust.

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<sup>282</sup> H.R. REP. NO. 779, 93d Cong., 2d Sess. 25 (1974).